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Supreme Court of the United States

October Term 1970

No. 1005

Bruzzese & Gumbinner, a partnership,

Petitioner,

—against—

Stanley S. Pearlstein,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Of Counsel

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Supreme Court of the United States

OCTOBER TERM, 1970

No. .....

SCUDDER & GERMAN, a partnership,

Petitioner,

—against—

STANLEY S. PEARLSTEIN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner, Scudder & German, respectfully prays that a Writ of Certiorari be issued to the United States Court of Appeals for the Second Circuit to review the decision of that Court reversing a judgment for Petitioner (the defendant) of the United States District Court for the Southern District of New York.

Opinions Below

The opinion of the District Court is reported at 295 F. Supp. 1197.

The opinion of the Court of Appeals and the dissenting opinion of Judge Friendly are reported at 429 F. 2d 1136 and 429 F. 2d 1145, respectively.

Jurisdiction

The judgment of the District Court dated July 24, 1968 was reversed by the Court of Appeals on July 2, 1970.

The orders of the Court of Appeals denying a petition for rehearing in banc, with Chief Judge Lumbard and Judges Moore, Friendly and Hays dissenting from the order in banc, were entered on August 24, 1970.

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §§ 1254(1) and 2101(e), and Rule 20 of the Rules of this Court.

Questions Presented

1. Whether Respondent has a private right of action against Petitioner, a partnership engaged in the securities business, for his loss on bonds purchased through or from Petitioner, based on Petitioner's not selling him out after he defaulted on the valid purchase agreements, there having been no inducement of the purchase, fraud, or misrepresentation by Petitioner.

2. Whether stipulations of settlement executed by Respondent and Petitioner to dispose of the controversies between them are valid and foreclose Respondent from recovery.

3. Whether a judgment of the Supreme Court of the State of New York entered upon a settlement agreement between Respondent and Petitioner, and an order denying a motion of Respondent to set aside that judgment, are *res judicata* and bar Respondent from relitigating issues that were raised and that could have been raised by him in the State court action.

Statutes and Rules Involved

The statutes and regulations involved in the determination of this case are:

(1) Sections 7(c) and 29(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), 15 U.S.C. §§ 78g(c) and 78cc(a).

(2) Rule 4(c) of Regulation T, 12 C.F.R. Part 220, § 220.4(c).

Statement

Respondent is an attorney, a practicing lawyer from 1936 to 1953. He was engaged after 1953 in stock market activities, constituting his sole source of income after 1956, and freelance writing. When he opened an account with Petitioner on February 20, 1961, he had maintained accounts with four other brokerage firms and had engaged extensively in the purchase and sale of convertible bonds.

At that time, convertible bonds registered on a national securities exchange presented a unique opportunity for a sophisticated trader who wanted to speculate on margin. The only limit then on a bank loan secured by such bonds, and made for the purpose of purchasing or carrying them, was whatever maximum might be "determined by the bank in good faith". Regulation U, 12 C.F.R. Part 221, §§ 221.1(a) and 221.3(r), as amended in 1959, 24 Fed. Reg. 3868, 3868-9.[1]

Moreover, then as now, a broker was permitted to arrange for such a bank loan, in whatever amount the bank

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[1] Only if the bonds were actually converted, the maximum bank loan values prescribed by the Board of Governors would become applicable, thirty days after conversion, to the stock into which the bonds had been converted. 24 Fed. Reg. 3867.

in good faith would lend, provided that the bank was subject to (and not violating) Regulation U,[1] and provided that the securities purchased or carried and used as collateral were registered on a national securities exchange. Regulation T, Rules 7(a), 111, 12 C.F.R. §§ 220.7(a), 220.111; 18 Fed. Reg. 5505 (1953).

In 1961, thirty per cent of current market value was the maximum that a broker could lend on any registered security. Regulation T, Rule 8(a), 12 C.F.R. § 220.8(a), as amended in 1960, 25 Fed. Reg. 7312. At that time, thirty per cent of current market value was also the maximum that a bank could lend on stock. Regulation U, Rule 4(a), 12 C.F.R. § 221.4(a), as amended in 1960, 25 Fed. Reg. 7313.

It was, however, permissible and customary for banks to lend much more, up to approximately eighty per cent of current market value, on registered convertible bonds, and for brokers to arrange for the loans. Convertibility gave such bonds market characteristics similar to those of stocks. The lack of margin limitations made the convertible bond a particularly attractive vehicle for speculation by experienced traders such as Respondent.

On the day he opened his account with Petitioner, Respondent purchased forty convertible bonds for $52,500, and borrowed $42,000 on them as collateral. On February 27, 1961, the settlement date, he paid the balance of $10,500. On March 6 he sold some of the bonds, at a profit, for $24,599. He used $20,000 to reduce the bank loan and ob-

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[1] Except with a bank subject to Regulation U, a broker could not properly arrange for a customer to borrow more than the broker could lend. Rule 7(a) of Regulation T, 12 C.F.R. § 220.7(a), provides that "this limitation shall not apply with respect to the arranging by a creditor for a bank subject to Part 221 of this Chapter (Regulation U) to extend or maintain credit on margin securities or exempted securities." That proviso was overlooked by the court below. See A26-7.

tain the bonds sold, and left $4,500 in his account with Petitioner.

Also on March 6 Respondent purchased $50,000 principal amount of convertible bonds of the Lionel Corporation (the "Lionel bonds") for $39,625, despite Petitioner's advice against the purchase. At Respondent's request, Petitioner arranged for a bank loan of $40,000 against the Lionel bonds. Petitioner would apply the $4,500 balance in Respondent's account toward that purchase. Respondent was obligated to pay the additional $7,027 by March 10, the settlement date fixed by his agreement with Petitioner.[3]

American Machine & Foundry Company ("AMF") had announced an issue of convertible bonds, and the bonds were being actively traded on the New York Stock Exchange on a when-issued basis. On March 7, Respondent informed Petitioner that he wanted to purchase $100,000 of the AMF convertible bonds. Petitioner recommended against the purchase, and reinforced its advice by telling Respondent it was selling the bonds short. When Respondent insisted on making the purchase, he agreed to make it through a short sale of the convertible bonds by Petitioner to Respondent, at the price next recorded on the ticker. That price was $150, resulting in a cost to Respondent of $150,062.

At Respondent's request, Petitioner inquired as to the amount that Respondent could borrow from a bank on the AMF bonds. Petitioner was told, and reported to Respondent, that bank financing was available to the extent of eighty per cent of the purchase price. Petitioner also told Respondent that the balance would have to be paid by Respondent on the settlement date, which would be the date

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[3] Rule 4(c) of Regulation T required Petitioner to arrange for payment by Respondent within seven business days after the purchase, i.e., by March 15. 12 C.F.R. § 220.4(c)(2) and (7).

when the bonds were issued. The written confirmation of the transaction so provides. When the date of issue was fixed at March 22, 1961, Respondent was advised by a second written confirmation of the transaction.[4]

As to both transactions, Respondent fully understood his obligations to pay the balances due on or before the settlement dates fixed, which were well within the limits set by Regulation T. Both purchase agreements, and the arrangements made for bank financing of both transactions, were valid and proper in all respects. The Lionel bonds and the AMF bonds were registered on the New York Stock Exchange, a national securities exchange. The lending banks were subject to and complying with Regulation U. Petitioner was in full compliance with Regulation T. Both purchases were made by Respondent at his own insistence and contrary to Petitioner's advice.

On March 8, 1961, after both purchases had been made, Respondent told Petitioner that he was being hospitalized for an operation. Petitioner advised Respondent to sell the convertible bonds, which could have been done at a profit, and thus avoid concern while in the hospital. Respondent refused to do so, and entered the hospital that afternoon.

On March 9, from the hospital, Respondent gave Petitioner an order to sell fifty of the AMF bonds at $155, but that price could not be obtained.

Respondent entered surgery on March 10, left the hospital on March 31, and was brought back on April 9 for emergency operations performed on April 10, 13, and 20. He was discharged on June 10. Meanwhile, the settlement dates fixed by the purchase agreements, and the later dates

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[4] Pursuant to Rule 4(c) of Regulation T, Petitioner was required to arrange for payment by Respondent within seven business days after March 23, i.e., by April 4, 1961.

fixed by Regulation T, had passed without performance of Respondent's promises to pay the balance due.

Petitioner made every possible effort to obtain payment, consistent with decent regard for Respondent's illness. Petitioner was prevented from communicating directly with Respondent, and was relegated to communications delivered through Respondent's mother and sister and through Evan Earle, Respondent's customer's man at Dean Witter & Co., where Respondent had his chief securities account.

Earle and Respondent were in touch with each other, and during his hospitalization Respondent had several securities transactions with Dean Witter & Co. and discussed them with Earle. Earle promised Petitioner several times that Respondent would make the payments due, but this never materialized. Through Earle, Petitioner's requested advice that Respondent sell the bonds was communicated to Respondent.[5]

On April 5 Petitioner received payment of $66,000 from the bank financing the Lionel bond purchase, and delivered the Lionel bonds to the bank. During May, Earle obtained respondent's signature in the hospital to a $100,000 note for a bank loan on the AMF bonds, which was not consummated as a result of Respondent's failure to pay the balance.

Twice in May, Petitioner wrote to Respondent demanding payment for the bonds. Receiving no response, Petitioner placed collection in the hands of counsel.

Petitioner and its attorneys engaged in continued efforts to collect the amounts due from Respondent. Respondent

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[5] Respondent admitted receiving such advice through Earle on March 17, two days after the expiration of his time for payment for the Lionel bonds under Regulation T and prior to the settlement date for the AMF bonds. The Lionel bonds could then have been sold at a profit. The market price of the AMF bonds ranged between a high of $150 and a low of $147½.

asked for more time, obtained legal advice, and consulted with the Securities and Exchange Commission, the New York Stock Exchange, and the National Association of Securities Dealers.

On August 7, 1961, Petitioner brought an action to recover the balance due on the Lionel bonds, and gave Respondent telegraphic notice, confirmed by certified letter, that it intended to sell the AMF bonds and hold Respondent liable for any deficiency between the purchase price and the amount received. The telegram and letter referred to Petitioner's repeated demands for payment, Respondent's numerous requests for extensions of time, and Petitioner's inability to wait any longer.

On August 8, following the consultations summarized above, Respondent telephoned Petitioner and offered to settle the pending controversies by liquidating his Lionel bond obligations in two installments, obtaining a bank loan of $100,000 on the AMF bonds, and paying $25,000 of the balance immediately and the rest in three months.

The settlement papers were prepared by Petitioner's counsel and consisted of two documents: (a) A stipulation of settlement in Petitioner's action to recover the balance owing on the Lionel bonds; and (b) An agreement for payment of the amount owing on the AMF bonds. On August 9 Respondent read the documents, discussed them, and signed them after having some changes made.

The initial payments required of Respondent by both settlement documents were due on August 11 and were made on that date, along with Respondent's execution of the required promissory notes. On August 21, Respondent borrowed $100,000 from a bank on the AMF bonds. The money was paid to Petitioner, and Petitioner delivered the AMF bonds to the bank that day, as collateral for the loan, pur-

count to the August 9 agreement. Respondent's debt to Petitioner was thus reduced from over $157,000 to less than $20,000.

Respondent's final payment on the Lionel bonds, due on September 15, was made on September 29, terminating the credit involuntarily extended on those bonds as a result of Respondent's default.

The final payment on the AMF bonds was due on November 9. Shortly before that date, Respondent requested a three-month extension. As a condition to granting that extension, Petitioner brought suit against Respondent in the Supreme Court of the State of New York for the balance due. A stipulation of settlement of that action was prepared by Petitioner's counsel, reviewed by Respondent, corrected pursuant to Respondent's suggestion, and executed.

In that stipulation of settlement, Respondent acknowledged his remaining $25,000 indebtedness to Petitioner, and agreed to pay it with interest by February 6, 1962. On and prior to that date he paid only $2,500 and tried for another extension, which was refused. On February 26, 1962, in accordance with the stipulation of settlement, judgment for $22,713 was entered in favor of Petitioner (plaintiff in the State court action) and against Respondent.

Respondent thereafter moved in the Supreme Court to set aside the judgment, alleging violations by Petitioner of Section 7 of the Exchange Act and of Regulation T in connection with the AMF bond transaction. While the motion was pending, Respondent commenced the instant action. Respondent's motion to set aside the State court judgment was denied on May 1, 1962. Respondent took no appeal, and subsequently paid the amount of the judgment.

The District Court held that Petitioner's failure to sell Respondent out, after Respondent had defaulted on his obligations to pay for the bonds he had purchased, constituted a violation of Regulation T and thus of Section 7(c) of the Exchange Act, and that Respondent had an implied right to sue for damages. The District Court also held that there was no showing of fraud, that Respondent was bound by the stipulations of settlement covering his claims against Petitioner in both transactions, and that the State Court judgment and order entered in respect of the AMF bond transaction were binding as *res judicata*. After the trial, judgment was entered for Petitioner.

The Court of Appeals reversed that judgment in a 2-1 decision. The majority held that Respondent had a right of action against Petitioner not provided for by statute but implied by the courts, that the stipulations of settlement were void under Section 29(a) of the Exchange Act, and that the prior adjudication by the State court did not bar Respondent's suit in the District Court.

Judge Friendly strongly dissented from the imposition of civil liability for the violation of securities law here involved, finding that it shocks the conscience and wars with common sense. He would affirm judgment for Petitioner, without reaching the claim that Respondent's action is barred by the stipulations of settlement and the judgment and order of the State court.

The order denying Respondent's petition for rehearing in banc notes the dissent of Chief Judge Lumbard and of Judges Moore, Friendly, and Haya.

Reasons for Granting the Writ

I. The Imposition on Petitioner of Liability for Respondent's Losses contravenes statutory and regulatory purposes and equitable principles.

Neither the Exchange Act nor Regulation T provides for a private right of action of a customer against a broker violating Section 7 of the Exchange Act, 15 U.S.C. § 78g, or the rules embodied in Regulation T, 12 C.F.R. Part 220.

This Court has never passed upon the implication of a private right of action for such a violation. There are lower court decisions that indicate that a customer's right of action may be implied where the broker induced him to buy securities on the assurance of an unlawful extension of credit.[4] Such a right of action, however, has never before been implied for a violation of Rule 4(c)(2) of Regulation T, 12 C.F.R. § 220.4(c)(2), requiring the broker promptly to "cancel or otherwise liquidate" a transaction if the customer does not make full cash payment within seven business days after the date of purchase.

Whatever disciplinary risks Petitioner may have taken by acceding to Respondent's desires, considering Respondent's situation as a hospital patient, and failing to sell him out, there is no statutory or equitable justification for enabling respondent to shift his losses to Petitioner.

Both Section 7 of the Securities Act and Regulation T were designed primarily to limit the aggregate amount of the nation's credit resources which could be directed by speculation into the stock market. Congress recognized

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[4] *Remar v. Clayton Securities Corp.*, 81 F.Supp. 1014 (D. Mass. 1949); *Cooper v. North Jersey Trust Co.*, 225 F.Supp. 972 (S.D. N.Y. 1964); *Jaeger v. Hertz, Neymark & Werner*, 426 F.2d 685 (2d Cir. 1970).

that some protection of the small speculator by making it impossible for him to spread himself too thinly would come as a "byproduct" of the margin provisions, but stated that this was not the main purpose of the statute. H. R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934) stated:

> "The main purpose of these margin provisions . . . is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose. The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry —to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry and agriculture, were drained by far higher rates into security loans and the New York call market."

Respondent's purchases here involved no violation of Section 7 or of Regulation T. Neither purchase was induced by Petitioner; on the contrary, Petitioner strongly advised against the purchases, and repeatedly advised Respondent to sell the bonds when Respondent could have done so and realized a profit.

It was Respondent's insistence on retaining the bonds, and Respondent's default on his valid purchase agreements, that caused Petitioner's subsequent violation not of

any margin provisions, but of the separate Rule 4(c)(2) governing the broker's treatment of a defaulting customer.

Rule 4(c)(2), the only rule of Regulation T that Petitioner violated, reflects no concern with protection of a defaulting customer against himself or against his broker. The rule provides:

> "(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)-(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof."

Rule 4(c)(5) of Regulation T, 12 C.F.R. § 220.4(c)(5), permits the broker to extend the period of payment to thirty-five days if the broker needs additional time to make delivery of the securities. There is no comparable latitude in the rules for a customer unable to pay within the seven days, no suggestion of any regulatory intention to create a cause of action for or otherwise to benefit a defaulting customer.

Customers who fail to pay on time for the securities they purchase present an enormously difficult problem for brokers generally. The back offices responsible for seeing that securities are received and delivered, and that payments are made and received, have been swamped by the enormous volume of security transactions. Apart from customers who fail to deliver or pay on time, there is a huge volume of "fails to deliver" and "fails to receive" resulting from the lack of perfection of back office procedures, equipment, and personnel.

There may be some merit in penalizing a broker whose inefficiency or negligence has injured an innocent customer.

There is no merit in making the broker subsidize the customer whose defaults have caused the trouble.

The decision below enables a defaulting customer speculating in bonds to place all the risk of market fluctuations on his broker, if the customer's persuasion or the broker's sympathy or negligence causes the broker to refrain from selling him out. It gives the defaulting customer a free ride at the expense of the broker, keeping the profit if the price goes up and shifting the loss to the broker if the price goes down. Any deterrent effect of threatened liability of the broker would be more than offset by the inducement of customers to delay payment for their purchases.

The majority of the Court below overlooked the basic distinction between cases such as this, where a valid and proper transaction is thrown off the track by a customer, and the altogether different cases where a broker is involved in a deliberate evasion of margin requirements.[1]

There are three cases in the Second Circuit that are in conflict with the decision below. *A. T. Bred & Co. v. Perlow*, 375 F. 2d 393 (2d Cir. 1967); *Serzysko* v. *Chase Manhattan Bank*, 409 F. 2d 1360 (2d Cir. 1969), affirming 290 F.Supp. 74 (S.D.N.Y. 1968), cert. denied 396 U.S. 904 (1970); *Moscarelli* v. *Stamm*, 288 F.Supp. 453 (E. D. N.Y. 1968).

In *Bred*, the Court sustained a broker's complaint against defendant customers who, according to the complaint, had purchased securities with the intent of paying for them only if their market value had increased by the date pay-

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[1] It appeared to the majority "that in 1961 a broker could not legitimately arrange a loan for the purchase of securities, secured by those same securities, for more than 50% of their value". In fact, as shown above, brokers could and did legitimately arrange much larger loans, provided that the lenders were banks subject to Regulation U, and provided that the securities were bonds registered on a national securities exchange.

ment was due. The price declined and the customers refused to pay. The broker did not act within the time provided by Regulation T, and thus extended credit in violation of Rule 4(c)(2). Later the broker sold the securities and incurred a loss. The Court held that the customers had caused the involuntary extension of credit by the broker, and that the broker's complaint stated a cause of action for recovery of the loss.

Serzysko involved a violation of Regulation U, 12 C.F.R. Part 221, by the defendant bank, induced by the plaintiff customer's misrepresentation of the purposes for which he would use the money borrowed. The customer sued to recover the loss he had incurred on the securities pledged with the bank and later sold by the bank, but recovery was denied.

The Court of Appeals affirmed the judgment of the District Court "for the reasons stated in the thorough and well reasoned opinion" of the District Judge. That opinion emphasizes that it would encourage borrowers to mislead lenders into violating Regulation U, 12 C.F.R. Part 221, if the borrower were permitted to "keep the profits if his speculation proved profitable and have the lender bear the loss if the speculation proved unprofitable. * * * It is the view of the Court that to allow the plaintiff to recover in this action would be to encourage rather than discourage deception on the part of investor-borrowers with resulting prejudice to the observance of the margin requirements of the Act." 280 F.Supp. at 89-90.

Regulation U, governing extensions of credit on securities by banks, is the counterpart of Regulation T, covering extensions of credit on securities by brokers. A customer or borrower who causes the violation by his broker or bank of Regulation T or Regulation U, and who speculates with the funds so acquired, and loses on his speculation, should not be permitted to shift his loss to the broker or the bank.

In *Moscarelli*, customers sued brokers to recover damages for losses resulting from trades on a securities exchange and moved for partial summary judgment based on the brokers' admission that they had violated margin requirements. The motion was denied, the court stating (288 F.Supp. at 459) that to permit a customer "who conspires or aids and abets the broker in violation of the provision of Section 7(c), to recover his losses from his broker, would defeat the very purpose of the section and the economic conditions which underlie its enactment."

Respondent here, like the customers in *Brod* and *Moscarelli* and the borrower in *Serayeko*, is an experienced speculator, who caused the violation of regulatory provisions on which his suit is based. The implication of a private right of action on his behalf would undercut the purpose of the rule that was violated as a result of his default.

The Exchange Act contains three specific provisions for civil liability. Section 9(e), 15 U.S.C. § 78i(e), provides for damage suits against a person who wilfully participates in unlawful manipulative activity. Section 16(b), 15 U.S.C. § 78p(b), provides for suits against an officer, director, or controlling stockholder for profits realized from a purchase of equity securities of his company within six months after a sale, or a sale within six months after a purchase. Section 18, 15 U.S.C. § 78r, provides for damage suits against the maker of false or misleading statements, in filings with the Securities and Exchange Commission, where the person sued did not act in good faith and knew that the statement was false and misleading.

There is no provision in the Exchange Act for a private right of action against the violator of the provisions of Section 7, 15 U.S.C. § 78g, or the rules (Regulation T and Regulation U, 12 C.F.R. Parts 220 and 221) adopted by the

Board of Governors of the Federal Reserve System pursuant thereto.

The courts have implied a civil remedy, by private litigation, for the violation of certain other provisions of the Exchange Act that are primarily designed for the protection of investors from unfair practices involving fraud and misrepresentation. See *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), involving misrepresentations in the solicitation of proxies in violation of Section 14(a), 15 U.S.C. § 78n(a), and *Pratt* v. *Robinson*, 203 F.2d 627 (9th Cir. 1953), involving fraud prohibited under Section 10(b), 15 U.S.C. § 78j (b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5. The justification for such implications of a private right of action is to effectuate the underlying policy and purpose of the statutory provisions.

In each of the lower court decisions cited above, where it was said that a violation of the margin requirements of Section 7 and Regulation T would sustain a complaint, the violations charged had induced the plaintiff's transactions. In each of those cases it could be argued that the statutory or regulatory provision violated (unlike Rule 4(e)(2) of Regulation T) was intended, at least in part, to protect an innocent customer from being induced to buy securities on inadequate margin.[8]

If the decision below were to stand, Respondent would have achieved the right to speculate for profit with Petitioner's money, and with Petitioner shielding him from loss.

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[8] Even there the implication of a cause of action by the lower courts has been questioned. See Comment, "Securities and Exchange Act of 1934—civil remedies based upon illegal extension of credit in violation of Regulation T", 61 Mich.L.Rev. 940, 944-7, 952-5 (1963); Note, "Federal margin requirements as a basis for civil liability", 66 Col.L.Rev. 1462, 1467-71 (1966).

It was Respondent who made the purchases, promised to pay, defaulted on his promises, and caused the involuntary extension of credit by Petitioner and his own ultimate loss. Respondent bought the bonds against Petitioner's advice, rejected Petitioner's advice to sell them, evaded Petitioner's demands for payment and (himself a lawyer) settled his controversies with Petitioner after obtaining legal and other professional advice. As the dissent below aptly puts it, equity and justice are qualities that his claim conspicuously lacks.

The decision below presents, and erroneously decides, an important question of federal law which has not been, but should be, decided by this Court.

2. *The stipulations of settlement executed by Respondent and Petitioner, purporting to dispose of the controversies between them, are valid and enforceable, and foreclose Respondent from recovery in this action.*

Respondent's evasion of Petitioner's efforts to collect the amounts due and thus terminate the credit involuntarily extended finally resulted in Petitioner's calling in counsel. Suit was brought for the $7,027 due on the Lionel bonds (held by Respondent's bank), and Respondent was advised that the AMF bonds would be sold unless payment were promptly made.

Respondent, a lawyer, was well aware of Regulation T, and consulted with another lawyer, the Securities and Exchange Commission, the New York Stock Exchange, and the National Association of Securities Dealers to help him decide what to do. Respondent then called Petitioner and offered to settle the pending controversies by payment of approximately $30,000 immediately, $100,000 through prompt consummation of a bank loan on the AMF bonds, and the balance of about $27,000 within three months. The proposed settlement required Petitioner to turn over the

AMF bonds to Respondent's bank against payment of the $100,000.

Respondent's proposal was embodied in settlement papers prepared, revised, and executed on August 9, 1961. As held by the District Court, Respondent "rationally acted of his own volition and voluntarily entered into the agreements of August, 1961 as well as the stipulation of November 8, 1961." 295 F. Supp. at 1205.

On August 11, pursuant to the August agreements, the first payments (approximately $30,000) were made. On August 21 the bank loan was consummated, the AMF bonds delivered to Respondent's bank, and the credit involuntarily extended by Petitioner to Respondent reduced by another $100,000. Further payments in small amounts were made, the credit on the Lionel bonds extinguished.

In November Respondent pleaded for more time to pay the final $23,500 due on or before November 9. Again of his own volition and voluntarily, he negotiated and executed a stipulation for a three-month extension of time and for entry of judgment in a State court action if he defaulted again. In that stipulation, Respondent acknowledged his debt to Petitioner and asserted that he had no defense to Petitioner's action on his AMF bond purchase.

The District Court held that Respondent's suit was barred by the stipulation of settlement executed in August and November 1961. The Court of Appeals reversed, on the basis of a majority holding that the stipulations are void under Section 29(a) of the Exchange Act, 15 U.S.C. § 78cc(a).

Section 29(a) provides:

> "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

The stipulations of August and November 1961 were agreements to settle, once and for all, the controversies between Respondent and Petitioner, and to terminate as promptly as possible the involuntary extensions of credit that gave rise to these controversies. Credits outstanding in the amount of over $157,000 were promptly reduced to less than $30,000 and were ultimately extinguished, as soon as practicable so far as Petitioner was concerned.

As held by the District Court, the parties to an existing controversy are not required by Section 29(a) of the Exchange Act, or otherwise, to litigate existing controversies between them. They are free to arbitrate such controversies or to settle them. Section 29(a) prevents the waiver of certain rights before a controversy arises, but that limitation is inapplicable to agreements made after the controversy has arisen. *Wilko* v. *Swann*, 346 U.S. 427, 438 (1953), and concurring opinion at 438.

The contrary holding of a majority of the court below would raise havoc with normal procedures for the disposition of private controversies under the securities laws. It is flatly in conflict with the decision of the Court of Appeals for the Third Circuit in *Moran* v. *Paine, Webber, Jackson & Curtis*, 389 F.2d 242 (1968).

In *Callen* v. *Pennsylvania RR.*, 332 U.S. 625, 630-1 (1948), this Court held that settlement of a claim after it arises is not barred by Section 5 of the Employers' Liability Act, which provides that any contract to enable a carrier to exempt itself from a statutory liability shall be void.

The fact that the controversies settled in this instance did not involve any liability provided for in the statute itself makes this an *a fortiorari* case for respecting the stipulations settling the controversies. For the courts to create by implication a cause of action, and then to rule

out the possibility of settling it, would be a capricious abuse of the judicial power.

Although the statute uses the term "void," the concept involved is one of "voidability". Even where it applies, its impact is not to make a nullity out of the agreements contained in the document, but rather to preclude their enforcement in a proper case where the defense is asserted by an innocent party, who has not waived his rights or lost them by estoppel or laches. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 387-8 (1970); *Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783, 792 (8th Cir. 1967); *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210, 213 (9th Cir. 1963); *Bankers Life & Casualty Co.* v. *Bellanca Corp.*, 288 F.2d 784 (7th Cir. 1961), cert. denied 368 U.S. 827 (1961).

As stated in Loss, "Securities Regulation", 1969 Supplement, page 3866:

> "One thing that is quite clear is that these voidability provisions do not make the contract *void*. Precisely as under § 12(1) of the 1933 act, 'The defrauded party has to bring a suit to rescind; the contract is voidable as to his rights since he can keep the stock or sue to rescind the sale'."

What he cannot do is to keep what he has received under the contract and refuse to pay for it. *Bankers Life & Casualty Co.* v. *Bellanca Corp.*, *supra*.

In *Greater Iowa Corp.* v. *McLendon*, *supra*, the Court said (378 F.2d at 792):

> "Though § 29(b) speaks in terms of 'void' and the guilty party is clearly precluded from enforcing the contract against an unwilling innocent party, just as clearly the innocent party is left free to enforce the contract if he so desires. This being true the contract cannot possibly

be considered absolutely and totally void. It is a contract 'voidable' at the option of the innocent party. * * * If this contract is 'voidable,' or void only at the option of the innocent party, the contract must be considered valid until voided by the party having the right of re[s]cission."

The innocent party may waive his statutory right to rescind, or be estopped from asserting such right. *Royal Air Properties, Inc.* v. *Smith, supra.*

By negotiating and executing the stipulations of August 9 and November 8, 1961, by retaining the Lionel bonds, and by acquiring the AMF bonds pursuant to the August 9 stipulation, Respondent ratified his agreements to pay for the bonds. If the alleged violations of Regulation T had ever given Respondent a right to rescind his purchases, his execution of the stipulations and his retention and receipt of the bonds waived that right and estopped him from exercising it months later, when this suit was instituted.

Even if the stipulations could properly be interpreted as violating Section 29(a), Respondent is not an innocent party entitled to rescission. The stipulations were made at his insistence, and he was the primary cause of any violation involved in the partial and temporary continuation of credit involuntarily supplied by Petitioner.

The majority of the court below cites no authority, and we know of none, for its casual use of Section 29(a) to wipe out the stipulations. Its decision is in conflict with applicable decisions of this Court, and involves an important question of federal law which should be settled by this Court.

3. The judgment and order of the Supreme Court of the State of New York are res judicata, and bar recovery on the AMF bond claims.

The District Court held that the judgment entered on settlement of the AMF action in the New York Supreme Court is *res judicata*, and bars relitigation of all matters which were or could have been raised in the State court action instituted by Petitioner.

After the entry of that judgment, Respondent had moved in the State court to have it set aside, alleging that Petitioner had violated Section 7 of the Exchange Act and Regulation T. The motion was opposed by Petitioner and denied by order of the State court.

The Regulation T issues on which Respondent bases his claim in this suit could have been raised in the State court by way of defense or counterclaim before judgment was entered, and were raised in his motion to vacate the judgment. Such issues can be and have been determined in the New York courts. *Irving Weis & Co.* v. *Offenberger*, 31 Misc. 2d 628, 220 N.Y.S. 2d 1001 (Mun. Ct. 1961); *E. F. Hutton & Co.* v. *Weinberg*, CCH Sec. Law Rep. '61-'64 Dec. ¶91,332 (Sup. Ct. N.Y. Co. 1964); *Billings Associates, Inc.* v. *Baskow*, 27 App. Div. 2d 124, 276 N.Y.S. 2d 446 (4th Dept. 1967).

The majority of the court below interprets the denial of Respondent's motion as based on jurisdictional grounds, and cites the dissenting opinion of Mr. Justice Rutledge in *Angel* v. *Bullington*, 330 U.S. 183, 204 (1947) as the basis for not giving effect to the New York judgment as *res judicata*.

It is the rule in New York, as well as in this Court, that a judgment entered upon a settlement, as here, is to be

enforced as *res judicata* although the facts were not litigated at trial. Litigation in any other proceeding is barred, as to all issues that could have been raised. *Pray* v. *Hegeman*, 98 N.Y. 351, 358 (1885); *Statter* v. *Statter*, 2 N.Y. 2d 668, 671-2 (1957); *United States* v. *Munsingwear, Inc.*, 340 U.S. 36, 38 (1950); *Chicot County Drainage District* v. *Baxter State Bank*, 308 U.S. 371, 378 (1940).

The issue here is not whether the State court judgment reflected a view of the law controlling on federal courts sitting in the State. The question is simply the binding effect on the parties of the State court adjudication. On that issue, there is no basis for the attempt of the majority below to distinguish *Angel* v. *Bullington*, *supra*.

The holding below that Respondent's suit is not barred by prior adjudication is a dangerous departure from this Court's application of the principles of *res judicata* to bring litigation to an end, and to promote certainty in legal relations. It suggests that State court litigation between broker and customer involving Regulation T and resulting in a final judgment could always be followed, if the customer were to lose, by federal court litigation raising the identical issues.

In this respect the decision below is in conflict with applicable decisions of this Court, and should be reviewed and reversed by this Court.

CONCLUSION

For the reasons stated, this petition for a writ of certiorari should be granted.

Dated: New York, N. Y.;
November 20, 1970.

Respectfully submitted,

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Hellerstein, Rosier & Rembar,
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APPENDIX A

District Court Opinion

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

DOCKET #43

62 Civ. 1383

STANLEY S. PEARLSTEIN,

Plaintiff,

—against—

SCUDDER & GERMAN,
a partnership,

Defendant.

Plaintiff, Stanley Pearlstein, institutes this action to recover damages, alleging that defendant, Scudder & German, illegally extended credit to plaintiff in violation of section 7(c) of the Securities Exchange Act of 1934 (hereinafter SEA), 15 U.S.C. § 78g(c), and Regulation T issued thereunder by the Board of Governors of the Federal Reserve System, 12 C.F.R. § 220. In addition, plaintiff alleges that defendant's handling of his account constituted a fraud on plaintiff in violation of section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and sections 10(b) and 15(c)(1) of the SEA, 15 U.S.C. §§ 78j(b) and 78o(c)(1).

On February 20, 1961, plaintiff, a licensed non-practicing attorney, opened a cash account with defendant, a partnership engaged as a broker-dealer in the securities business. On the same day plaintiff purchased through defendant 20 Richfield Oil convertible bonds for $28,345.84 and 20 Phillips

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Petroleum convertible bonds for $24,163.33, a total of $52,509.17 (Ex. 1).[1] Payment for the bonds was made as follows: $42,000 was obtained from a bank loan for which the bonds were used as collateral; the remainder of the purchase price, $10,509.17, was paid by check dated February 27, 1961 (Ex. 2).

On March 6, 1961, plaintiff sold the Phillips bonds through defendant. Plaintiff realized $24,598.53 therefrom, of which $20,000 was used to reduce the bank loan and obtain the release of the Phillips bonds. The sum of $4,598.53 was retained in plaintiff's account with defendant. Also on March 6th, plaintiff purchased through defendant, acting as broker, 50 convertible bonds of the Lionel Corporation (hereinafter Lionel bonds). The total cost of the bonds, including accrued interest and commissions, was $59,625.41. Defendant arranged a $48,000 bank loan against the bonds (Ex. 5), leaving a balance of $7,026.88[2] due from plaintiff. The bonds were registered on the New York Stock Exchange (hereinafter NYSE), and the delivery or settlement date was March 10, 1961.

On March 7, 1961, plaintiff purchased from defendant, as dealer, on a when-issued basis, 100 convertible bonds of the American Machine and Foundry Corporation (hereinafter AMF bonds) for $150,082.64. The bonds, registered on the NYSE, were made available for distribution on March 23, 1961. Defendant had advised plaintiff against the wisdom of both the Lionel and AMF purchases, and,

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[1] "Ex." followed by a number or letter refers to an exhibit in evidence.

[2] The $7,026.88 figure represents the balance of $11,625.41 owing after the $48,000 loan, less the $4,598.53 already in plaintiff's account from the Phillips transaction.

with plaintiff's knowledge and consent, defendant's sale of the AMF bonds to plaintiff was a short sale.

Plaintiff entered New York Hospital on March 8, 1961 and underwent surgery on March 10th. He was discharged from the hospital on March 31st, but returned on April 9th, on an emergency basis, and underwent emergency operations on April 10th, April 13th, and April 20th. He was discharged from the hospital on June 10, 1961.

Beginning in May, 1961, defendant attempted by letters and telephone calls to secure payment from plaintiff of at least some portion of the money due on the AMF bonds. By August 7, 1961, however, plaintiff had made no payment on account thereof nor had he paid the balance due on the Lionel bonds. On August 7, 1961, defendant sent plaintiff notice that it intended to sell the AMF bonds on August 9th unless payment was received by that date or as soon thereafter as practicable (Exs. 13, 14). Also on August 7th, plaintiff was served with a summons and complaint in an action by defendant in the Supreme Court of the State of New York, New York County, to recover $7,138.57 owing in connection with the Lionel bonds, plus interest (Ex. 15).

Plaintiff entertained doubts about the legality of the AMF transaction and had, prior to this time, consulted an attorney, Truman Luhrman. In addition, plaintiff, on August 8, 1961, made inquiry of the Securities and Exchange Commission (hereinafter SEC), NYSE and National Association of Securities Dealers (hereinafter NASD) about the AMF transaction. These interviews apparently led him to believe that there was nothing illegal about the transaction.

The next day, August 9, 1961, plaintiff executed a stipulation settling the Lionel action (Ex. 17). The stipulation

called for installment payments which were duly made. Also on August 9th, plaintiff executed an agreement with defendant relating to the AMF bonds (Ex. 16): Plaintiff agreed to pay $25,000 in cash by the close of business on August 11, 1961 and defendant agreed to extend to plaintiff a $25,000 three-month loan. In addition, defendant agreed to make efforts to obtain a $100,000 bank loan, secured by the AMF bonds. The money was paid on August 11, 1961 and the required promissory notes were executed (Exs. 18, 22, 23).

In early November, 1961, plaintiff requested, and defendant granted a three-month extension of the $25,000 loan due on November 9th. Pursuant to that agreement, defendant instituted an action on November 8, 1961 against plaintiff in the Supreme Court of the State of New York, New York County, by the service of a summons (Ex. 24), to recover the $25,000. Also in pursuance of the agreement, plaintiff on November 8th signed a stipulation settling the action and agreeing to pay the $25,000 by February 8, 1962 (Ex. 25).

Plaintiff made part payment of $2,500 under the stipulation of settlement, but failed to pay the balance. Judgment was entered in the Supreme Court, February 26, 1962, against plaintiff, in accordance with the stipulation, in the sum of $22,712.81. The amount of the judgment was subsequently paid by plaintiff. In April, 1962, shortly after the instant suit was begun, plaintiff moved in the Supreme Court (Index No. 3520/1962) to vacate the judgment. Justice Hecht, on May 1, 1962, denied the motion.

Between May 29, 1962 and April 19, 1963, the banks which held the $48,000 Lionel note and the $100,000 AMF note sold the bonds for plaintiff's account. By this action

plaintiff seeks to recover damages in the amount of $59,600 on the AMF bonds and $26,466.27 on the Lionel bonds, representing the difference between the purchase price of the bonds and the price at which the banks sold them.

Regulation T

Section 7(a) of the SEA, 15 U.S.C. § 78g(a), provides that "[f]or the purpose of preventing the excessive use of credit for the purchase or carrying of securities," the Board of Governors of the Federal Reserve System shall prescribe rules and regulations governing the extension and maintenance of credit.

Congress has additionally provided, in section 7(c) of the SEA, 15 U.S.C. § 78g(c), that:

> "It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—
>
> (1) On any security (other than an exempted security) registered on a national securities exchange, in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section."

Regulation T, 12 C.F.R. § 220, issued by the Board of Governors pursuant to section 7(a), provides, in pertinent part, that:

> "In case a customer purchases a security (other than an exempted security) in the special cash account and

does not make full cash payment for the security within 7 days[3] after the date on which the security is so purchased, the creditor[4] shall, except as provided in subparagraphs (3)-(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof." 12 C.F.R. § 220.4 (c)(2).

In addition, even if the customer were thereafter to offer full payment, the broker-dealer must not accept such payment and consider the provisions requiring cancellation or liquidation to have been met. 1940 FRB 772, noted at 2 CCH Fed. Sec. L. Rep. ¶22,216.16.

Thus the crucial date by which payment of the unpaid balance on the Lionel bonds had to be made was March 15, 1961. As of that date, however, payment had not been made. Consequently, defendant's failure to cancel or liquidate at that time constituted a violation of Regulation T and of section 7(c).[5]

With respect to the purchase of the AMF bonds on a when-issued basis, the applicable rule is stated in 12 C.F.R. § 220.4(c)(3):

"If the security when so purchased is an unissued security, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is made available by the issuer for delivery to purchases [sic]."

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[3] "The 7-day periods specified in this paragraph refer to 7 full business days." 12 C.F.R. § 220.4(c)(7).

[4] "The term 'creditor' means any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member." 12 C.F.R. § 220.2(b).

[5] It is uncontested that the bonds were non-exempt and that none of the exceptions in § 220.4(c) apply to the Lionel bonds.

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The AMF bonds became available for delivery on March 23, 1961, but no payment had been made by plaintiff as of April 4, 1961. Defendant's failure to cancel or liquidate at that time constituted a violation of Regulation T and of section 7(c).

Private Right of Action

It is now well settled that although the SEA does not expressly give a right or remedy to a private person injured by a violation of section 7(c), such a right may nonetheless be implied. Applying the principle of 2 Restatement, Torts § 286 (1934) that where violation of a prohibitory statute has caused injury to an individual, the latter has a right of action if one of the purposes of the enactment was to protect individual interests (like the plaintiff's), the courts have held that a private right of action is to be inferred from section 7 of the SEA. *Smith* v. *Bear*, 237 F.2d 79 (2d Cir. 1956); *Cooper* v. *North Jersey Trust Co.*, 226 F.Supp. 972 (S.D.N.Y. 1964); *Reader* v. *Hirsch & Co.*, 197 F.Supp. 111 (S.D.N.Y. 1961); *Remar* v. *Clayton Securities Corp.*, 81 F.Supp. 1014 (D. Mass. 1949); *Appel* v. *Levine*, 85 F.Supp. 240 (S.D.N.Y. 1948); see *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964).

A report of the House Committee on Interstate and Foreign Commerce recognizes that "[t]he main purpose" of section 7 "is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market. . . .". H. R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934). However, Congress also recognized that "protection of the small speculator by making it impossible for him to spread himself too thinly . . . will be achieved as a byproduct of the main purpose." *Id.* "Thus, section 7(c) does seek to protect individual investors and

results in the creation of an implied statutory right." *Reader* v. *Hirsch & Co., supra* at 115.

Defendant's violation of section 7(c) and of Regulation T promulgated pursuant thereto gives plaintiff a right of action to recover from defendant any loss sustained as a proximate consequence of defendant's violation. *Smith* v. *Bear, supra; Warshow* v. *H. Hentz & Co.*, 199 F.Supp. 581 (S.D.N.Y. 1961); *Remar* v. *Clayton Securities Corp., supra.*[6] However, in view of our determination that plaintiff's rights under the SEA and the applicable regulations were extinguished by his settlements of two New York State Supreme Court actions involving the Lionel and AMF bonds, we do not decide the extent to which plaintiff has suffered damages proximately caused by defendant's violation.

Stipulations of Settlement

It is our view that when the parties entered into the stipulations of August 9, 1961 and November 8, 1961 (Exs.

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[6] Although we agree with defendant's contention that the proof fails to show that defendant induced plaintiff to purchase the Lionel and AMF bonds in violation of Regulation T, we reject defendant's conclusion that the absence of inducement negates the existence of a private right of action. The fact that there was no agreement at the inception of the purchase contracts that plaintiff need not pay for the bonds within the prescribed 7-day periods surely cannot destroy an investor's rights—especially when those rights mature only after the broker-dealer has failed to liquidate or cancel in a timely fashion and has caused injury to the investor. A contrary conclusion would render illusory the remedies created for investors by Congress. But see *E. F. Hutton & Co.* v. *Weinberg*, CCH Fed. Sec. L. Rep. ¶ 91,332 (Sup. Ct. 1964); *Irving Heis & Co.* v. *Offenberger*, 31 Misc. 2d 628, 220 N.Y.S. 2d 1001 (N.Y. City Mun. Ct. 1961) (characterized by Professor Loss as a "confused opinion in which [the] court referred to Regulation T as 'a rule of an exchange' . . ." 2 L. Loss, *Securities Regulation* 1264 n. 75 (Supp. 1962). It is to be noted that there is no implied right of action under a rule of an exchange. See *Colonial Realty Corp.* v. *Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966)).

17, 25), settling the suits brought by defendant for sums due on the Lionel and AMF purchases respectively, they in effect removed all controversy surrounding the legality of the purchases and substituted valid and binding settlements which effectively bar recovery in this action. These stipulations superseded the existing controversies between the parties and constituted new agreements entitled to be enforced without regard to the validity of the original claims or defenses thereto. *Yonkers Fur Dressing Co., Inc.* v. *Royal Insurance Co., Ltd.*, 247 N.Y. 435, 160 N.E. 778 (1928); *American Progressive Health Insurance Co.* v. *Chartier*, 6 A.D. 2d 579, 180 N.Y.S. 2d 181 (1st Dept. 1958). The claims made by plaintiff in this action could have been advanced in the state court actions, as was done by the customer of a broker-dealer in *Billings Associates, Inc.* v. *Bashaw*, 27 A.D. 2d 124, 276 N.Y.S. 2d 446 (4th Dept. 1967). Having chosen, instead, to settle the actions, plaintiff is foreclosed from litigating the issues here.

As we find no merit to plaintiff's objections to the binding effect of these settlements, we find them to be valid, enforceable, and dispositive of the instant case.

Section 29(a) of the SEA, 15 U.S.C. § 78cc(a) provides:

> "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

Although plaintiff, in his Post-Trial Memorandum, does not pursue the contention, raised in his Amended and Supplemental Complaint, ¶ 21, that the stipulation of settlement entered on November 8, 1961 with respect to

the AMF transaction was illegal and invalid in that it violated the above-quoted section,[7] we have examined, in view of the broad formulation of the settlement issue in the Pre-Trial Order,[8] both the AMF and Lionel stipulations in the light of section 29(a).

Section 29(a) has been judicially construed to preclude only those waivers of SEA provisions and rules and regulations thereunder made prior to the existence of a controversy. It does not prevent or invalidate stipulations settling controversies already in existence or actions already instituted. See *Wilko* v. *Swan*, 346 U.S. 427, 438 (1953) (concurring opinion); *Moran* v. *Paine, Webber, Jackson & Curtis*, 389 F.2d 242 (3d Cir. 1968), *aff'g* 279 F.Supp. 573 (W.D. Pa. 1967); *Reader* v. *Hirsch & Co., supra; Moran* v. *Paine, Webber, Jackson & Curtis*, 422 Pa. 66, 220 A. 2d 624 (1966).

In view of the fact that the settlements were entered into after the commencement of state court actions, plaintiff's contention that the stipulations did not settle any actual controversy between the parties lacks merit. Further, the proof reveals that although plaintiff, prior to August 9, 1961, had disputed liability, questioned the validity of the transactions, paid visits to the SEC, NYSE, and NASD, and spoken with an attorney, he expressed a desire to settle "the two claims" (Transcript p. 291). In addition, when plaintiff signed the stipulation of settlement of No-

[7] No such allegation was made in the Amended and Supplemental Complaint with respect to the stipulation of settlement of August 9, 1961 involving payment for the Lionel bonds.

[8] "Were the stipulations of settlement entered into between plaintiff and defendant in actions in the Supreme Court of the State of New York valid and enforceable and do they bar recovery in this action?" Pre-Trial Order, ¶ 8(4).

vember 8, 1961, he knew that defendant had received a letter from the SEC about the AMF transaction as to which he still owed $25,000. It is therefore apparent that plaintiff did settle with defendant actual controversies involving the Lionel and AMF purchases, and that such settlements do not violate section 29(a).

Plaintiff further contends that the stipulations of settlement of the state court actions are void in view of section 29(b) of the SEA, 15 U.S.C. § 78cc(b), which provides in pertinent part:

> "Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract . . ."

It is plaintiff's argument that in view of section 7(c)'s ban on the maintenance of credit in violation of Regulation T, the stipulations of settlement, as agreements continuing illegal credit, violate the above-quoted language of section 29(b) and are therefore void. This contention lacks merit and fails to diminish the binding force of the settlements.

Plaintiff recognizes that a contract within the purview of section 29(b) "cannot possibly be considered absolutely and totally void." *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 792 (8th Cir. 1967). Rather, it is only the con-

tract rights of the party in violation of the statute which are voided. The contract rights of the party not in violation are in no way impaired, and the innocent party may enforce the contract if he so desires. *Id.*; see, *e.g.*, *Bankers Life and Casualty Co.* v. *Bellanca Corp.*, 288 F.2d 784 (7th Cir.), *cert. denied*, 368 U.S. 827 (1961).

Applying this standard to the facts before us, the most we can say for plaintiff's argument is that the performance of the original purchase agreements involved the continuance of a relationship in violation of Regulation T, in that defendant failed to cancel or liquidate upon plaintiff's non-payment within the prescribed period.[9] Even assuming that such an arrangement was voidable at plaintiff's option, the execution of the stipulations created an entirely new relationship between the parties. Rather than continue illegal credit, the stipulations represented the intention of the parties to make "a fresh start." *Yonkers Fur Dressing Co., Inc.* v. *Royal Insurance Co., Ltd.*, *supra* at 444, 160 N.E. at 781. Whatever illegality inhered in their relations prior to the execution of the stipulations of settlement was submerged by the mutual creation of a new contractual relationship. By the terms of the stipulations, provisions were made for payment on account of earlier purchases. To say that the stipulations were themselves void and that such settlements can now be set aside runs counter to the general policy in favor of the settlement of existing disputes. The thrust of plaintiff's argument on this point seemingly leads to the untenable result that it would never be possible to settle issues arising from violations of the credit and margin regulations and that all such

[9] *Contra*, *Billings Associates, Inc.* v. *Beshaw*, *supra*.

controversies would have to be litigated. This would impose a wholly unreasonable requirement not intended by Congress.

In further assault on the stipulation of August 9, 1961 settling the Lionel action, and also on the agreement of August 9, 1961 (Ex. 16) providing for terms of payment for the AMF bonds, plaintiff alleges (Amended and Supplemental Complaint, ¶¶ 18, 33) that these agreements were coerced by defendant and are therefore voidable.[10] In support of his contention, plaintiff presented two expert witnesses who treated him during the relevant period: Dr. Melvin Fishman, a psychologist, and Dr. Jack Richard, an internist.[11] While we credit so much of their testimony which establishes that from March, 1961 onward plaintiff was agitated, depressed and anxious, we are not impressed with their conclusions that plaintiff's judgment was so impaired that he was unable to represent himself adequately. Even less convincing, in our estimation, was the testimony of plaintiff himself dealing with his alleged susceptibility to coercion. It is our view, in the light of plaintiff's extensive market experience as well as the testimony of Messrs. Scud-

[10] The Amended and Supplemental Complaint contains no allegation of coercion with respect to the stipulation of settlement of November 8, 1961.

[11] Defendant renews its motion, made during trial, to strike in toto the testimony of Dr. Fishman. We sustain its admissibility for the reason set forth in open court (Transcript p. 126). Defendant also renews its motions to strike the opinion evidence of Drs. Fishman and Richard with regard to plaintiff's ability to engage in transactions in issue in this case. In view of the relationship between these expert witnesses and plaintiff and their consequent personal knowledge of his condition, we deny defendant's motions and sustain admissibility. See *Jenkins* v. *U.S.*, 307 F.2d 637, 643, 644 (D.C. Cir. 1962).

der and Zolotar relating to their dealings with plaintiff during 1961, that plaintiff, intent on retaining the Lionel and AMF bonds, rationally acted of his own volition and voluntarily entered into the agreements of August, 1961 as well as the stipulation of November 8, 1961. Whatever emotional problems plaintiff may have had are insufficient to invalidate transactions with layman who had no reason to doubt his rationality.

Res Judicata

Although the stipulations of settlement are dispositive of the instant litigation, we note also that the judgment entered on the settlement of the AMF action in the New York Supreme Court is res judicata and bars relitigation in this court of all matters which were or could have been raised in the state court action instituted by defendant. See, *e.g.*, *Chicot County Drainage District* v. *Baxter State Bank*, 308 U.S. 371, 378 (1940).

It has been held by this court that a judgment entered upon a settlement, as here, is to be given res judicata effect although the facts were not litigated at trial. In *Stuyvesant Insurance Co.*, v. *Dean Construction Co.*, 254 F.Supp. 102 (S.D.N.Y. 1966), *aff'd per curiam*, 382 F.2d 991 (2d Cir. 1967), Judge Bryan stated:

> "There is no doubt that a judgment entered upon a settlement is res judicata as to all questions which were or could have been litigated in the action in which the judgment was entered. [citing cases] . . .
>
> • • • •
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> ". . . Thus the judgment . . . entered on the settlement operates as a bar . . . and 'prevents relitigation

of all grounds for, or defenses to, recovery that were then available to the parties before the particular court rendering the judgment, in relation to the same claim—regardless of whether all grounds for recovery or defenses were judicially determined.' 1B Moore, Federal Practice ¶ 0.405, at 622 (2d ed. 1965). . . .

"It is immaterial that the settlement entered into was improvident or that . . . rights to raise constitutional and other questions in the state litigation were unwisely relinquished or abandoned. Res judicata guards against such hindsight as was displayed here. The principle of res judicata, particularly appropriate in these proceedings, 'seeks to bring litigation to an end and promote certainty in legal relations.' United States v. Munsingwear, Inc., 340 U.S. 36, 38, 71 S. Ct. 104, 106, 95 L. Ed. 36 (1950)" *Id.* at 110, 111.

In order for the prior judgment to have res judicata effect in the instant litigation, the two actions must be "upon the same claim or demand." *Saylor* v. *Lindsley*, 391 F.2d 965, 968 (2d Cir. 1968). That requirement is satisfied here, as the prior action was instituted by defendant in the course of collection of payment for the AMF bonds, and the judgment entered in the case resolved the payment issue on the basis of plaintiff's affirmance of the transaction and payment for the bonds. The stipulation settling the action specifically recited plaintiff's affirmation "that he has no defense to this action." (Ex. 25, ¶ 1). We find that the instant litigation, in which plaintiff seeks to undo the AMF purchase, is based on the same claim which was the subject of the state court action and that we are thus barred from reopening in this forum the prior litigation. Al-

though § 27 of the SEA, 15 U.S.C. § 78aa, confers exclusive jurisdiction on the federal courts to hear actions arising under the Act, plaintiff could have raised his section 7 and Regulation T arguments as defenses in the state court action. See, *e.g.*, *Billings Associates, Inc.* v. *Bashaw, supra; Remington Rand Inc.* v. *International Business Machines Corp.*, 167 Misc. 108, 3 N.Y.S. 2d 515 (Sup. Ct. 1937).

Subsequent to the entry of judgment on February 26, 1962, plaintiff did in fact move in the New York State Supreme Court to set aside the judgment, alleging that defendant had violated section 7 of the SEA and Regulation T in the purchase of the AMF bonds. Defendant opposed the motion by affidavits, and while it was pending, plaintiff commenced the instant action. In his decision denying the motion on May 1, 1962, Justice Hecht expressly decided that: "... The defendant [Stanley Pearlstein] has submitted no substantial reason to set aside the judgment. His remedy is by way of the independent action which he states has been commenced in the federal court. . . ." [12] (Transcript p. 365).

Accordingly, it is our view that plaintiff, faced with the choice of contesting the suit against him by raising defenses based on defendant's alleged violation of the SEA

[12] We do not construe the latter sentence as reflecting any belief by Justice Hecht that the state courts are without power to consider a defense that a cause of action does not lie by reason of a violation of a federal statute. Nor do we interpret it as expressing a view that Pearlstein might be successful in this court. Rather, it would appear that Justice Hecht, without expressing any opinion as to the probability of success of a federal court action or as to the validity of any claim or defense that might be raised there, meant to convey that the state court judgment was not subject to attack on the proffered grounds and that Pearlstein's only opportunity for relief lay in his federal court action.

or settling the action and retaining the bonds, opted for the latter course and thereby waived the right to litigate the questions raised in this action.

There is no merit to plaintiff's contention that the judgment is subject to attack because plaintiff settled the state court action while under the mistaken belief that he had to pay for the bonds. There is no evidence whatsoever that Mr. Zolotar misrepresented the state of the law to plaintiff, and, as we pointed out earlier, plaintiff himself was an attorney and experienced trader, and had consulted another attorney prior to the execution of the agreements of August, 1961. The proof reveals that plaintiff wanted to keep the bonds and voluntarily agreed to do so, not that he was fraudulently induced into so doing.

Likewise we see no reason for altering our disposition of the res judicata issue because of the omission from the affidavits submitted by defendant and its attorney to the New York State Supreme Court (in opposition to plaintiff's motion to set aside the judgment of February 26, 1962) of the fact that a representative of the SEC had informed defendant that it had apparently violated Regulation T in its handling of the AMF transaction (Ex. 30).[13] Justice Hecht was not bound by the contents of that letter, and he rendered his decision upon a record in which both parties argued the Regulation T issue. Although Justice Hecht made no express ruling on whether or not defendant did violate Regulation T, the existence of Exhibit 30 could have had no binding effect had he chosen to rule on the question.

[13] Defendant renews its motion, made at trial, to strike the correspondence between defendant and an SEC representative (Exs. 28, 29, 30). We adhere to our ruling that these exhibits are admissible, not for the truth of the matters contained therein but to show the existence of correspondence between defendant and the SEC and on the issue of the credibility of defendant's witnesses.

Appendix A
District Court Opinion

Anti-Fraud Provisions

One aspect of plaintiff's contention that defendant violated the anti-fraud provisions of the Securities Act of 1933 and the SEA, 15 U.S.C. §§ 77q(a), 78j(b), and 78o (c)(1), is that defendant, by failing to cover the short sale of the AMF bonds to plaintiff as soon as the bonds became available on March 23, 1961, was in a position to speculate against plaintiff without putting up its own money. As authority for this proposition plaintiff cites SEC Release No. 34-6778, Reg. § 241. 6778 (April 16, 1962), 2 CCH Fed. Sec. L. Rep. ¶¶ 22, 696-698, which states, in essence, that in any transaction between a broker-dealer and his customer, there is an implied representation by the broker that, in accord with reasonable trade custom, the transaction will be consummated promptly unless there is a clear understanding to the contrary.

We find the contention unimpressive, for plaintiff has utterly failed to adduce any convincing proof which even suggests that defendant's conduct was fraudulent in any respect. Rather, the record reveals that defendant secured plaintiff's permission to sell short to him, and that as of March 23, 1961, plaintiff had not yet made payment for the AMF bonds. There is no indication that defendant acted in any manner as to the short sale other than in accord with normal trade custom. Moreover, plaintiff does not dispute defendant's interpretation of Release No. 34-6778 as applying only to short sale situations in which the broker-dealer has received payment from his customer. We find that whatever irregularity might have inhered in the AMF transaction from the standpoint of Regulation T did not constitute a fraud.

Similarly, there is no merit to plaintiff's allegation that defendant violated the anti-fraud provisions by its use of economic pressure and misrepresentation that plaintiff was liable for losses thereby coercing plaintiff into taking the AMF bonds in August, 1961. We have already touched on this issue in our discussion of the stipulations of settlement and the res judicata defense. It is sufficient here to repeat only that there is no evidence that defendant or its attorney misrepresented the state of the law to plaintiff, and that we are satisfied that plaintiff acted voluntarily throughout the period in question.

Statute of Limitations

Defendant's contention that plaintiff's action is time barred is without merit. As to the allegation of fraud resulting from a violation of a rule or regulation prescribed pursuant to § 15(c)(1) of the SEA, 15 U.S.C. § 78*o*(c)(1), to which the one-year statute of limitations contained in section 29(b) of the SEA, 15 U.S.C. § 78cc(b) applies, we find that even assuming defendant guilty of fraudulent practices, plaintiff's action would not be time barred. The action was commenced on April 5, 1962, less than one year after any possible fraud was, or by the exercise of due diligence could have been discovered. See *Goldenberg* v. *Bache & Co.*, 270 F.2d 675 (5th Cir. 1959).

Defendant, relying on *Goldenberg*, argues that plaintiff's claim based on section 7 of the SEA and Regulation T promulgated thereunder is also barred by the one-year statute of limitations contained in section 29(b). The short answer to this contention is that the one-year limitation in section 29(b) is expressly limited to actions based on "violation of any rule or regulation prescribed pursuant to paragraph

(1) of subsection (c) of section 78*o* of this title . . ." 15 U.S.C. § 78cc(b), and does not affect actions brought under section 7 and Regulation T.[14]

Defendant's motion to dismiss the action is granted. Judgment for defendant.

The foregoing shall constitute this Court's Finding of Fact and Conclusions of Law, pursuant to Rule 52, F.R.Civ.P.

So Ordered:

New York, N.Y.
July 24, 1968

/s/ Irving Ben Cooper
United States District Judge

[14] Professor Loss comments as follows with regard to this issue:

"In Goldenberg v. Bache & Co., 270 F.2d 675, 680 (5th Cir. 1959), the court erroneously applied this [one-year] statute of limitations to a customer's damage action against her broker for violation of Regulation T, . . . presumably because the plaintiff had attempted to make a violation of § 15(c)(1) out of the case." 3 L. Loss, *Securities Regulation* 1771 n. 296.

APPENDIX B

Court of Appeals Opinion

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 92—September Term, 1969.

(Argued November 5, 1969 Decided July 2, 1970.)

Docket No. 33315

STANLEY S. PEARLSTEIN,

Plaintiff-Appellant,

—v.—

SCUDDER & GERMAN, a Partnership,

Defendant-Appellee.

Before:

WATERMAN, FRIENDLY and SMITH,

Circuit Judges.

Plaintiff-appellant, who alleged that in their dealings the appellee had violated federal securities laws, seeks reversal of judgment entered below, United States District Court for the Southern District of New York, Cooper, *J.*, for appellee.

Reversed and remanded.

JOSEPH TIEFENBRUN, HENRY CONAN CARON, of counsel, New York City, *for appellant.*

MYRON S. ISAACS, Hellerstein, Rosier & Rembar, New York City, *for appellee.*

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WATERMAN, *Circuit Judge*:

Appellant Stanley S. Pearlstein, the plaintiff below, sued Scudder & German, a partnership engaged in the securities business, for damages which he alleged he suffered because the defendant had violated the margin and antifraud provisions of the federal securities laws.[1] Plaintiff's allegations

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[1] Section 7(c) of the Securities Exchange Act of 1934, 15 U.S.C. §78g(c) states:

§78g. Margin requirements

* * * * *

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) On any security (other than an exempted security) registered on a national securities exchange, in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section.

Regulation T of the Federal Reserve System, 12 C.F.R. §220.4(c)(2) promulgated pursuant to 15 U.S.C. §78g(a), reads in part:

In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in sub-paragraphs (3)-(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

The seven days referred to above refer to seven full business days. 12 C.F.R. §220.4(c)(7).

The antifraud provisions cited by plaintiff are Section 17(a) of the Securities Exchange Act of 1933, 15 U.S.C. §77q(a)(1)-(3), Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j(a) & (b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. §240.10b-5.

grew out of two distinct purchases of bonds he brought through the defendant, who acted as his broker. Although these transactions overlapped in time they can best be described separately. The first of these, which can be termed the "Lionel transaction," began on March 6, 1961, when plaintiff bought fifty convertible bonds of the Lionel Corporation for a total price of $50,625.41 despite defendant's advice against the purchase. Plaintiff financed this purchase partly through a bank loan of $43,000 arranged by the defendant against the bonds and partly through a payment to defendant of $4,368.53 in cash. These two payments fell short of the purchase price by $7,256.88, however, and plaintiff continued to owe this balance to the defendant. Under Federal Reserve System Regulations[1] the payment of this sum was due on March 15, 1961, seven business days after the date of purchase. Plaintiff did not pay any portion of this balance by that day. As payment had been delayed beyond the permissible time, defendant was obligated by law to sell the bonds on plaintiff's account. However, defendant made no such sale but, instead, on April 5, transferred the bonds to the lending bank as security for its loan and did not even demand of the plaintiff payment of the balance due until June 8. Finally, on August 7, plaintiff was served with a summons in a suit instituted by defendant to collect this sum.

At about this time plaintiff must have developed serious doubts as to the legality of his debt to defendant, both in this transaction and in that described below. He consulted a lawyer concerning the matter, and on August 8 he visited the Securities and Exchange Commission, the New York

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[1] Regulation T, *supra* note 1.

Stock Exchange, and the National Association of Security Dealers. He was everywhere told that his obligation was valid. The following day, August 9, plaintiff entered into a stipulation of settlement in the suit defendant had commenced, promising to pay the sum he owed in two installments on August 11 and September 30, 1963. Plaintiff made both payments on schedule. The bank which held the bonds as security for its loan to plaintiff eventually sold them in three lots on May 11 and May 16, 1962, and April 19, 1963, for a total price of $22,150.14. Thus Pearlstein suffered a total loss of $30,466.27 on his purchase of Lionel bonds.

The second or "AMF" transaction germane to this lawsuit involves the purchase by plaintiff, on a "when issued" basis, of 100 convertible bonds of the American Machine and Foundry Company ("AMF"). Once again plaintiff made the purchase contrary to defendant's advice, at a total price of $130,062.50. Defendant had a short position in these bonds and told plaintiff that it could furnish him his bonds upon their issuance by AMF in the near future from this short position. Plaintiff agreed. The bonds became available for purchase on March 23, 1961 and payment under Regulation T should have been made April 4. Although payment was not made by that date defendant did not demand payment of any part of the total sales price until May 22, 1961. After various subsequent requests for payment were ineffectual defendant threatened plaintiff with legal action in August. On August 9, 1961, the same day that Pearlstein entered into the stipulation of settlement respecting the Lionel bonds, the parties entered into an agreement with regard to the AMF bonds as well. The agreement provided that defendant would attempt to arrange a bank loan of $100,000 secured by the

bonds, and Pearlstein would pay the defendant the additional $30,000 himself in two equal installments on August 11 and November 8, 1961. The bank loan was accordingly arranged for and Pearlstein made the first payment of $25,000 on August 11 as scheduled. However, he was unable to meet the November 8 payment and he obtained an extension from defendant until February 8, 1962. In return for this extension plaintiff signed a confession of judgment in a suit the defendant had commenced against him that same day. This document provided that defendant could obtain a judgment against plaintiff for the debt owed without further notice to him. Plaintiff failed to make payment on February 8, 1962, and, pursuant to the confession, judgment was accordingly entered against him in the Supreme Court of New York for $22,712.81, a sum reflecting adjustments for several payments made by plaintiff on the one hand and for interest and costs accruing to defendant on the other. Eventually the lending bank sold the AMF bonds on May 29, 1962, at a price which caused plaintiff to suffer a total loss of $38,000 on the AMF transaction.

After he had begun the present lawsuit in the federal court below plaintiff sought to reopen the New York judgment of $22,712.81 which defendant had obtained. The New York judge, Hecht, *J.*, dismissed his motion, suggesting that plaintiff's remedy, if any, lay in the federal courts. Pearlstein did not appeal.

Plaintiff was hospitalized for surgery on two occasions during these transactions. The lower court found, however, that plaintiff's ill health did not affect his capacity to understand and evaluate his business dealings.

In the instant case Pearlstein sought to recover from defendant the difference between the amounts he would

have received for the Litvak and AMF bonds if defendant had sold them on his account on the day payment was due and the amounts actually received when the banks sold the bonds much later. In seeking these damages plaintiff alleged not only that defendant had violated the securities laws, but also that it committed fraud. The court below held that plaintiff had standing to sue for damages under Section 7(c) of the Securities Exchange Act of 1934 and that defendant had violated both this section and Regulation T of the Federal Reserve System. However, the court also held that plaintiff was bound by the stipulations of settlement he had entered into with defendant in both transactions and that the judgment entered in the AMF transaction amounted to *res judicata*. The court also held that plaintiff had not been treated fraudulently.

We agree with the district judge below that defendant violated the federal securities laws by extending credit to the plaintiff and that Pearlstein has a right of action against the defendant. We disagree, however, with the holding that the stipulations of settlement and the New York judgment in the AMF transaction bar this suit. Accordingly, we reverse and remand for further proceedings consistent with the approach taken in this opinion.

At the outset we express reservations as to the legality of the size of the loans, up to two thirds of the value of the bonds, which defendant procured for plaintiff—a matter quite distinct from the length of time defendant extended credit to plaintiff. It appears from our own examination of the relevant law[2] that in 1961 a broker could

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[2] See 12 C.F.R. §§220.2(b), 220.3(b), and 220.8(a); *Warshaw v. H. Hentz & Co.*, 189 F. Supp. 581 (SDNY 1961).

not legitimately arrange a loan for the purchase of securities, secured by those same securities, for more than 30% of their value. The parties have not raised this issue, however, and for that reason we do not deal with it except to call the matter to the attention of the parties and of the district court on remand.

In this regard to Regulation T, upon which the plaintiff bases this suit, it seems reasonably clear that defendant violated federal law when it failed in each instance to sell the bonds after seven business days had expired without payment. No reason appears why such a sale could not easily have been accomplished in the case of the AMP bonds, either by repurchase on the part of the defendant, who had sold plaintiff the bonds from its own short position, or by resale to third parties. The Lionel bonds present a somewhat more difficult problem, in that a loan secured by the bonds had been arranged by the defendant at the outset of the transaction, and defendant was under an obligation to transfer the bonds to the bank when the loan was executed. The record does not divulge whether title to the securities was also to pass to the bank at the time the loan was made. However, in any event it appears that whereas payment on the bonds was due from plaintiff on March 15, 1961, defendant did not deliver the bonds to the bank or receive the proceeds of the loans from the bank until April 5. At the time payment was due, therefore, any contract of the plaintiff with the bank was still executory, and it lay within the power of defendant to refuse delivery of the bonds, thus cancelling the loan agreement and crediting in its place a liability in Feuerstein for whatever portion of the bank's expected interest the bank

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might require in damages.[6] Brokers have been held in violation of the margin requirements when they arranged illegal bank loans as well as when they extended credit themselves,[7] and we think an equal duty exists to take reasonable steps to prevent (at no risk to the broker) the execution of a transaction which has become illegal subsequent to the arrangement of a loan to finance it.

We also hold that Pearlstein has a right of action against Scudder & German for its violation of Section 7. Although the congressional committee report which recommended the enactment of Section 7 indicates that the protection of individual investors was a purpose only incidental to the protection of the overall economy from excessive speculation,[8] it has been recognized in numerous cases since that time that private actions by market investors are a highly effective means of protecting the economy as a whole from margin violations by brokers and dealers.[9]

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[6] Under New York law, a party to a contract who renders its performance illegal by his own fault appears to be liable for breach. See *Dalman* v. *United States Trust Co.*, 266 Misc. 929, 191 N.Y.S.2d 508, 511, aff'd, 1 App. Div. 2d 669, 148 N.Y.S.2d 699, rev'd on other grounds, 2 NY2d 110, 157 N.Y.S.2d 537, 139 N.E.2d 734; Restatement of Contracts §§457, 458.

[7] See *Brenner* v. *Goldman*, 361 F.2d 759 (1 Cir.), cert. denied, 385 U.S. 932 (1966); *Worshow* v. *H. Hentz & Co.*, 199 F. Supp. 501 (SDNY 1961); *Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014 (D. Mass. 1949).

[8] Report of the House Committee on Interstate & Foreign Commerce, H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934). See Note, Federal Margin Requirements as a Basis for Civil Liability, 66 Colum. L. Rev. 1462, 1470-1471 (1966).

[9] See, e.g., *Jaeger* v. *Hertz, Neumark & Warner* (2 Cir. May 6, 1970); *Smith* v. *Bear*, 237 F.2d 79, 87-88 (2 Cir. 1956); *Scoppetto* v. *Chase Manhattan Bank*, 280 F. Supp. 74 (SDNY 1968), aff'd mem. 399 F.2d 1009 (2 Cir.), cert. denied, 393 U.S. 984 (1969); *Moccarelli* v. *Simms*, 266 F. Supp. 452 (SDNY 1966); *Glickman* v. *Schweickart & Co.*, 242 F. Supp. 670 (SDNY 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964); *Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014 (D. Mass. 1949).

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The defendant asserts that these cases limit investor recovery to those situations where the broker has deliberately and willfully induced the investor to buy securities on the assurance of an unlawful extension of credit. Here, defendant submits, it was the plaintiff who fraudulently induced the broker to enter into these transactions. Pearlstein was knowledgeable in the securities field, and defendant attributes to him a conscious plan to profit from the illegal extension of credit if the bonds increased in price and to sue the defendant for damages if their prices declined.

In our view, defendant's statement of the law is incorrect. The federal securities laws charge brokers and dealers with knowledge of the margin requirements and with the duty to obey them. No broker can conscientiously claim to have been misled into extending credit beyond the seven-day limit absent some misstatement of fact by his customer regarding the customer's use of the money loaned, see *A. T. Brod & Co. v. Perlow*, 375 F.2d 393 (2 Cir. 1967), a circumstance which is not present here.

Whether Pearlstein also knew of the margin requirements is unclear in the absence of some specific finding on that point by the lower court, although his unfruitful trips to the Securities and Exchange Commission and the New York Stock Exchange several months after the commencement of these transactions would seem to indicate that he may have been merely suspicious as to the illegality of the credit given him. However, our holding does not turn on Pearlstein's subjective knowledge of the law. In our view the danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private suits for com-

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pensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission.[1] As the district court observed in *Scoggins v. Chase Manhattan Bank*, 320 F. Supp. 74, 87-88 (SDNY 1968), *aff'd mem.*, 409 F.2d 1300 (2 Cir.), *cert. denied*, 396 U.S. 904 (1969), the defense of *in pari delicto* in securities law cases has been undermined by the recent antitrust case of *Perma Life Muffler, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). There the Court held that the doctrine of *in pari delicto* would not bar a retailer from suing a manufacturer for antitrust violations when the retailer had been coerced into joining the illegal agreement.

Although *Perma Life* would apparently continue to deny recovery to plaintiffs who had not been coerced but who had benefited from the arrangement equally with the defendant, such a defense does not appear desirable in the securities area here involved, even when the investor may be shown to have had knowledge of margin requirements. Unlike the antitrust laws which forbid both seller and buyer to enter into a proscribed transaction, the federally imposed margin requirements forbid a broker to extend undue credit but do not prohibit customers from accepting such credit. This fact appears to indicate that Congress has placed the responsibility for observing margins on the broker, for the original need for margin requirements undoubtedly derived from the common desire of investors to speculate unwisely on credit. Moreover, whereas brokers are charged by law with knowledge of the margin requirements, the extent of an investor's knowledge of these rules would frequently be difficult of tangible proof.

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[1] Cf. *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

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The cases cited by defendant need not be read to contradict this view of the law.[9] Although two of them do indicate that certain kinds of contributory fault may bar suit against a broker in this context,[10] the kinds of contributory fault there involved go beyond knowledge of the margin requirements to commitment or misstatement of

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[9] Several cases cited by defendant deal not with the investor's right to recover for the broker's failure to sell unpaid-for securities after seven days, but rather with the broker's right to sue for the original contract price after plaintiff has failed to tender payment and the broker has accordingly sold the securities on the investor's account. See *A. P. Smith & Co. v. Perkins*, 205 F.2d 899 (2 Cir. 1957); *Dillon Securities, Inc. v. Bakony*, 27 App. Div. 2d 855, 278 N.Y.S.2d 425 (1967); *E. F. Hutton & Co. v. Weinberg*, 1969-64 CCH Sec. L. Rep. ¶91,888 (Sup. Ct. N.Y. 1964); *Irving Weis & Co. v. Oppenheimer*, 31 Misc.2d 625, 220 N.Y.S.2d 1021 (Mun. Ct. 1961). Plaintiff does not contest his liability for the original contract price, but rather seeks to limit his loss to that which he would have sustained had defendant sold the bonds after seven days. Other cases cited by defendant are also inapposite. In *Simonelli v. Shearson*, 280 F. Supp. 429 (SDNY 1968), the court denied plaintiff's motion for summary judgment because plaintiff had allegedly conspired with various of the defendant broker's employees to extend credit, where the defendant sold the securities as soon as it discovered the illegality, and where the employees were not acting within the scope of their employment or apparent authority in granting the credit. *Scoggin v. Chase Manhattan Bank*, 280 F. Supp. 74 (SDNY 1968), *aff'd mem.*, 409 F.2d 1329 (2 Cir.), *cert. denied*, 396 U.S. 902 (1969) involved material and deceptive misstatements of fact on the part of the plaintiff investor at the time he opened the credit, as to the purpose for which he intended to use it. In *Brower v. Goldman*, 401 F.2d 729 (1 Cir.), *cert. denied*, 393 U.S. 982 (1968), the court found that the defendant broker had not violated the margin requirements, so that the court did not reach the question of plaintiff's right to recover any damages he could show he suffered because of a violation.

[10] See *Scoggin v. Chase Manhattan Bank*, 280 F. Supp. 74 (SDNY 1968), *aff'd mem.*, 409 F.2d 1329 (2 Cir.), *cert. denied*, 396 U.S. 902 (1969) and *Simonelli v. Shearson*, 280 F. Supp. 429 (SDNY 1968), both discussed supra note 9.

material facts. Consequently we decline either to follow or to attack these holdings.

We next turn to the lower court's holdings that plaintiff's suit is barred by the stipulations of settlement which he entered into with defendant and by the judgment entered in the AMF transaction in the New York Supreme Court. As to the settlements, the court below recognized that a simple agreement between the parties that plaintiff would pay if defendant extended further credit would be void under Section 29(a) and (b) as a contract made in violation of the rule against extension of credit. However, in both transactions involved here, defendant had commenced lawsuits before plaintiff signed a stipulation of settlement in the Lionel matter and a confession of judgment in the AMF suit. The court held that these agreements served to settle the actions, that they did not continue illegal credit but served as a "fresh start" in the relationship of the parties, and that to hold otherwise "seemingly leads to the untenable result that it would never be possible to settle issues arising from violation of the credit and margin regulations and that all such controversies would have to be litgated." 295 F. Supp. at 1204.

We disagree with this logic. First, we hold that the settlements did involve the promise by defendant of a continuation of credit which was illegal under the Act. Defendant argues that because it had already delivered the bonds to the lending banks in each transaction, it could not have sold them even if it wanted to, and therefore did not extend any more credit than it already had extended. However, defendant should have used its best efforts to secure the return of the bonds which it had improperly delivered to the banks, by replevin if neces-

sary, and to sell them. Defendant's failure to take such action resulted in a continuation of credit in violation of Regulation T, and under Section 29(b) of the Securities Exchange Act, 15 U.S.C. §78cc(b), the stipulation is void.

Even apart from the continuing ability of Scudder & German to liquidate the bonds on plaintiff's account, we think that the stipulations do not bar this suit. Assuming that plaintiff and defendant both believed that it was impossible for defendant to sell the bonds after their delivery to the bank, the plaintiff's primary motive to enter into the stipulation was undoubtedly the desire to gain enough time to meet his debt, thus avoiding an immediate judgment which might precipitate his bankruptcy or at least cause him serious financial strain. Nevertheless, it was defendant's very failure to sell the bonds on time which produced this financial difficulty on the part of plaintiff, for if the Lionel bonds, at least, had been sold seven days after their purchase date they would have yielded a gain rather than a loss. Thus if plaintiff did waive any of his rights, he appears to have done so under financial pressures directly resulting from defendant's violation of Regulation T.

Finally, even if defendant could not have sold the bonds and if plaintiff were not induced to sign the stipulation because of any financial pressure, it would nonetheless contravene public policy to give the stipulation conclusory effect. Section 29(a) of the Securities Exchange Act holds void any stipulation obligating a party to waive compliance with the Act. Although the lower court held that waivers of rights under the Act may be given effect if the waivers occur after the commencement of suit, the cases cited only stand for the proposition that the remedial

right of access to the courts after an active controversy has arisen can be waived knowingly in favor of arbitration. Here it is difficult to say that Pearlstein's waiver was knowing, given the apparent lack of any inducement to give up his rights other than financial pressure. But if the waiver were knowing, it would not secure some desirable end such as arbitration, easily compatible with the broad purpose of the Act, but would instead serve only to legalize the very extension of credit which the margin requirements seek to prevent and which suits such as this one serve to discipline. Indeed, brokers could routinely extend credit beyond margin simply by delivering bonds to third-party lenders before they have been paid for by the customer, and then immediately commencing suit against the customer for the difference, obtaining a waiver in return for a stay of judgment. Such a possibility clearly militates against any bending of the language of Section 29(a) to accommodate the stipulations here involved.

We now turn to defendant's claim, concurred in by the lower court, that plaintiff's action regarding the AMF bonds is barred by the *res judicata* effect of the consent judgment entered in the New York court February 6, 1962. Defendant argues and the district judge held that Pearlstein could have raised the violation of federal law as a defense in that action, and his failure to do so must preclude this suit. Cf., e.g., *Stuyvesant Ins. Co. v. Dean Constr. Co.*, 254 F. Supp. 102 (SDNY 1966), aff'd mem. sub nom. *Stuyvesant Ins. Co. v. Kelly*, 382 F.2d 991 (2 Cir. 1967).

Pearlstein did attempt to raise his federal issue in the state court by means of a motion to reopen the judgment after its entry. The New York Supreme Court, per Hecht, J., denied this motion, observing only that "The defendant

Appendix B
Court of Appeals Opinion

[Pearlstein] has submitted no substantial reason to set aside the judgment. His remedy is by way of the independent action which he states has been commenced in the federal court."

The confession of judgment signed by Pearlstein in the AMF transaction was invalid for the reasons just discussed. The doctrine of *res judicata* has in the past been held subordinate to principles of public policy, see, e.g., *Spilker* v. *Hankin*, 188 F.2d 35 (D.C. Cir. 1951); *Denver Bldg. & Constr. Trades Council* v. *NLRB*, 186 F.2d 326 (D.C. Cir. 1950), *rev'd on other grounds*, 341 U.S. 675 (1951). Here, the same arguments which make the original confession of judgment invalid apply with equal strength in favor of refusing to bar the instant suit because of a judgment entered pursuant to that agreement. Cf. *Donald F. Duncan, Inc.* v. *Royal Tops Mfg. Co.*, 343 F.2d 655 (7 Cir. 1965), holding that a consent judgment obtained by fraud or mutual mistake cannot be used to invoke *res judicata*.

It could be argued by defendant that even though the New York judgment was voidable, plaintiff's failure to appeal Judge Hecht's refusal to reopen the judgment does operate as *res judicata* and precludes him from raising the same arguments in another court. However, we do not view the New York judgment as affecting the merits of the federal controversy now before us. Although we agree with the lower court that Judge Hecht's dismissal of plaintiff's motion to reopen the suit does not by its language compel the conclusion that the suit was dismissed for lack of jurisdiction, it certainly is indicative of that determination, and we so hold. New York courts have held that federal law may serve as a defense to a state claim but may not be utilized as the basis for an affirmative re-

covery.[11] Because federal law indicates a securities buyer's liability for the purchase price is not expunged by subsequent margin violations,[12] it appears that Pearlstein's recovery from his broker for margin violations would have to assume the form of a setoff or counterclaim to the broker's claim for the purchase price; this would be the sort of affirmative recovery under federal law which New York courts will not entertain.[13]

We conclude that jurisdictional grounds constitute the reason for the dismissal of Pearlstein's motion to reopen the judgment. It is therefore difficult to see why Pearlstein's suit should be barred in the very federal courts which the New York court recommended to him when it

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[11] *See Standardbred Owners Ass'n, Inc.* v. *Yonkers Raceway, Inc.*, 35 Misc. 1091, 232 N.Y.S.2d 346 (Sup. Ct. 1962), *aff'd* mem. 245 N.Y.S.2d 956 (App. Div. 1963); *Remington Rand, Inc.* v. *International Bus. Mach. Corp.*, 167 Misc. 188, 3 N.Y.S.2d 515 (Sup. Ct. 1937), and cases cited therein at 3 N.Y.S.2d 522.

[12] As pointed out in note 9 *supra*, *Irving Weis & Co.* v. *Offenberger*, 31 Misc.2d 628, 220 N.Y.S.2d 1001 (Mun. Ct. 1961); *E. F. Hutton & Co.* v. *Weinberg*, 1961-64 CCH Sec. L. Rep. ¶91,232 (Sup. Ct. N.Y. 1964); and *Billings Associates, Inc.* v. *Haahaa*, 27 App. Div. 2d. 124, 276 N.Y.S.2d 446 (1967) all dealt with the question whether a violation of federal margin requirements by the broker relieved the customer of his obligation to pay for the bonds at all. The cases hold that the customer must pay absent deliberate inducement by the broker to make an illegal purchase. Pearlstein, however, does not seek in this case to challenge his liability for the original purchase price by any such allegation which would have been available to him in the New York Court.

[13] It is perhaps possible that New York law would permit the assertion of federal law as a defense in this case by holding that title to the bonds vested in Scudder & German after the passage of seven days from date of purchase, so that the broker's claim would be limited to its damages and not to the purchase price of the bonds, but we find no precedent that would appear to support this view of New York law.

overruled his motion. Normally, a denial of jurisdiction by one court will not preclude consideration of the merits by a second court which does have jurisdiction, see, e.g., *Smith* v. *McNeal*, 109 U.S. 426 (1883). And as Mr. Justice Rutledge stated in dissent in *Angel* v. *Bullington*, 330 U.S. 183, 204 (1947), a point not contradicted by the majority in that case, the policy favoring *res judicata* has never been so strong.

> ". . . that the matter is ended simply by showing that a party has had some chance, however slight, in a previous litigation to secure a favorable decision.
>
> If this were the law every case where a party takes a nonsuit or a dismissal expressly for the purpose of starting over again would be a final and conclusive determination against him. I know of no jurisdiction where the law has been so harsh. Nor do I think it should be in this one." [14]

Accordingly, we conclude that Pearlstein's suit here is not barred by any prior adjudication elsewhere.

One point remains for consideration: Pearlstein's assertion that defendant's conduct in this case amounted to fraud. Plaintiff asserts that defendant had not actually

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[14] It might be argued that *Angel* v. *Bullington*, 330 U.S. 183 (1947) does impart *res judicata* effect to the New York judgment here concerned, but the case is readily distinguishable. There the Court held that a state court ruling on the jurisdiction of state courts was in fact a ruling on substantive law, applicable to federal courts in that same state through *Erie R.R.* v. *Tompkins*, 304 U.S. 64 (1938), but as the Court pointed out, 330 U.S. at 192, "Of course, where resort is had to a federal court not on grounds of diversity of citizenship but because a federal right is claimed, the limitations upon the courts of a State do not control a federal court sitting in the State."

acquired the AMF bonds which it was to sell plaintiff from its short position until well after the settlement date, and that defendant was thereby enabled to speculate on the price of the bonds without actually committing its own money. We do not understand how defendant actually benefited from this delay in acquiring the bonds, nor how the delay especially damaged the plaintiff. In any event, we find it quite unnecessary to make any determination with reference to this assertion.

Accordingly we reverse and remand to the district court to determine the proper measure and amount of damages. We leave open the question whether defendant's liability for the bonds' decline in price ended when they were sold by the bank or was terminated at some earlier date.

FRIENDLY, *Circuit Judge* (dissenting):

This case illustrates the need for putting some brakes on the onrush of civic obligation for violation of the securities laws if that doctrine is to be an instrument of justice rather than the opposite. With all respect, the scholarly opinion of my brother WATERMAN seems to me to reach a conclusion that shocks the conscience and wars with common sense. Apart from the unfairness of the result on the facts of this case, press reports of "backroom troubles" of many brokerage houses and the sharp decline in security prices could give the decision far-reaching consequences.

Although the opinion's statement of facts is accurate as far as it goes, a somewhat fuller narrative is needed to place the matter in proper setting: Plaintiff Pearlstein was a practicing lawyer from 1936 to 1953. Since 1956, his time

has been spent in investment activity and unsuccessful attempts at free-lance writing. Before opening an account with Scudder & German on February 20, 1961, he had accounts with four other brokerage firms and had engaged in extensive convertible bond transactions. He financed these by having the broker arrange bank loans for a large portion of the cost, as the law then permitted.[1] The convertible bonds were pledged as collateral, and Pearlstein paid cash for the balance.

Pearlstein's first transactions with Scudder & German were carried out in accordance with this practice and with applicable regulations. On February 20, 1961, he purchased 20 Richfield convertible bonds and 20 Phillips Petroleum convertible bonds for $52,500, borrowed $42,000 on them as collateral, and paid the balance of $10,500 on February 27, 1961, the settlement date. On March 6 he sold the Phillips convertibles for $24,500. He used $20,000 of this to reduce the bank loan and obtain the Phillips bonds and left the balance in his account.

Out he same day Pearlstein purchased $50,000 principal amount of Lionel convertible bonds for $50,625. While there is a dispute whether defendant recommended against the purchase, Pearlstein does not maintain that the broker

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[1] The majority's suggestion, not advanced by the plaintiff, that in 1961 a broker could not legitimately arrange a bank loan for more than 30% of the value of securities ignores the fact that a broker arranging for a bank subject to Regulation U to extend credit on registered securities is not limited by the conditions on which he himself could make the loan. 12 C.F.R. §221.3(t) in 1968, 33 Fed. Reg. 2705, the margin requirements of Regulation U applied to loans on convertible bonds only after the conversion privilege had been exercised. See 24 Fed. Reg. 2567-68 (1959). No doubt it was this very liberality that attracted Pearlstein, as it did many others, to speculate in convertible bonds.

encouraged it in any way. A $42,00 bank loan was arranged, and plaintiff was obligated to pay the additional $7027 above the balance in his account by March 10. The next day, March 7, he informed defendant that he wanted to purchase $100,000 of American Machine & Foundry convertibles on a when-issued basis. Defendant not merely recommended against this but reinforced its advice by telling Pearlstein it was selling the bonds short. When Pearlstein insisted on going forward, he agreed that defendant would make a short sale to him at the price next recorded on the ticker, viz., 150. At his request defendant investigated bank financing and told him this could be procured to the extent of 80%. The difference would have to be paid when the bonds were issued, to wit, March 23, if Pearlstein had not sold them by that time.

On March 8 Pearlstein advised defendant that he was being hospitalized for an operation. Scudder testified that he advised Pearlstein to sell his securities, which could have been done at a profit, and avoid concern. Pearlstein declined, and entered the hospital that afternoon. Next day, from the hospital, he ordered defendant to sell 50 of the AMF bonds at 155, but that price could not be obtained. He left the hospital on March 31 but on April 9 was brought back on an emergency basis. He underwent operations on April 10, 13 and 20, and was in danger of losing his leg and, indeed, his life. He was not discharged until June 10. Meanwhile the date fixed by Regulation T for payment of the Lionel bonds occurred on March 15 and that for payment of the AMF bonds on April 4.

Defendant did what it could to obtain payment, short of closing out the transactions, which it had every reason to

think the sick man did not want. On April 5 it received payment of $68,000 from a bank on account of the Lionel bonds and delivered them as collateral. Unable to communicate directly with Pearlstein, it called Earle, his customer's man at Dean Witter & Co., where he had his chief stock account, and his mother and sister. Earle promised payment several times but this never materialized; he conveyed no suggestion that Pearlstein wished the bonds to be sold.[2] During May, Earle obtained Pearlstein's signature in the hospital to a $110,000 note for the AMF bonds. However, as a result of Pearlstein's failure to pay the balance of $40,083, this was not consummated. On two occasions during May defendant wrote letters demanding payment on the AMF bonds. There being no response, it placed the collection in the hands of counsel. On plaintiff's discharge from the hospital, he obtained legal advice and consulted the SEC, the New York Stock Exchange, and the NASD. After this he voluntarily entered into the settlements outlined by my brother Waterman. At no time did he indicate any desire that defendants sell the bonds—indeed, he specifically requested additional time to pay his debts. He now asks that, because of defendant's having indulged his desire to retain his securities, it should pay him for the depreciation of the AMF bonds until their sale in May 1962 and of

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[2] Pearlstein admitted that on March 17 Earle informed him of defendant's recommendation for sale. The Lionel bonds could then have been sold at a profit. The AFM bonds ranged between a high of 150 and a low of 147½; Pearlstein could have sold the Lionel bonds at a profit until mid-June; the AMF bonds again sold over 150 on seven trading days in April.

the Lionel bonds until their sale in April 1963, in a total amount of $95,000, plus many years interest.[3]

It is common ground that defendant violated §7(c) and Regulation T and thereby subjected itself to the possibility of discipline and even of criminal penalties, although those in charge of such matters evidently decided against doing anything. I recognize also that violations of these provisions may give rise to civil liability in appropriate cases, under any of several theories. See 5 Loss, Securities Regulation 3296-304 (1969). But this is not an appropriate case.

Regardless of the theory under which it is sought to establish civil liability, the starting point for discussion is whether imposition of such liability will further the purposes behind the statute and the regulation. It is thus desirable to begin by examining just what the purposes of §7(c) were.

The legislative history of that section[4] affords scant evidence that protection of the investor loomed at all large in the Congressional mind. Although passages in the Senate hearings and a later Senate report indicate that an important purpose of the Senate bill was "to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin," the upper house was con-

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[3] Although the majority leaves open whether defendant's liability for depreciation of the bonds may have ended at an earlier date, it suggests no principle to aid the district court in making this determination. At the very least it should be made clear that defendant has no liability for depreciation of the Lionel bonds after it had been fully paid. In saying this I do not mean to imply that an earlier cut-off might not be appropriate even on the majority's view.

[4] A helpful Note, Federal Margin Requirements as a Basis for Civil Liability, 66 Colum. L.Rev. 1462, 1467-71 (1966), gives the references for the developments cited in the following discussion.

sidering a bill that placed the administration of the credit requirements in the same agency, then the Federal Trade Commission, that was to enforce the rest of the Securities Exchange Act. The change, initiated by the House of Representatives and concurred in by the Senate, whereby determination of allowable credit was placed in the Federal Reserve Board, has been said to demonstrate "that concern for the investor was wholly subordinated to the achievement of macro-economic objectives."[5] In fact, the report of the House Committee, H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), stated:

> The main purpose of these margin provisions . . . is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose.
>
> The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be diverted by speculation into the stock market and out of other more desirable uses of commerce and industry —to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry and agriculture, were drained by far higher rates into security loans and the New York call market.

[5] *Id.* at 1469.

While it thus may be wrong to say that concern for the investor was "wholly subordinated" to the effect of excessive credit on the economy, the history surely does not indicate a Congressional desire that the courts should engage in an all-out effort to utilize §7(c) to protect investors against themselves, no matter how offensive the result.[6]

With deference to my brother WATERMAN's contrary view, I doubt whether permitting the customer to shift the risk of market decline to the broker is generally either necessary or desirable as a means of furthering the primary purpose of §7(c). Occasional and isolated violations of Regulation T do not threaten to cause a significant alteration in the allocation of credit in the economy; only widespread or repeated violations would pose a danger. But it is in just such situations that we may confidently expect application of the administrative and criminal sanctions provided by the Act. The economic purpose behind §7(c) thus causes the provision to differ from those portions of the securities acts more directly aimed at protection of investors. With misleading proxy statements, for instance, one violation does threaten the purpose of the Act *pro tanto*, and since the SEC cannot catch all such violations before the fact, a privately imposed sanction, whether before or after, is appropriate. See *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 431-35 (1964); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 381-85 (1970). So also in regard to alleged derelictions by directors of investment companies, *Brown* v. *Bullock*, 294 F.2d 415 (2 Cir. 1961), and still more obviously

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[6] The dominating fiscal purpose of §7(c) is further shown by a ruling of the Federal Reserve Board that the creditor may not accept payment even if this is tendered promptly after the 7-day period. 1940 Fed. Res. Bull. 773.

with respect to the anti-fraud provisions of the securities laws.

Even assuming that the purpose of §7(c) would be served by a degree of private enforcement, I question whether the majority's free-wheeling approach will have the desired effect. As a result of it, speculators will be in a position to place all the risk of market fluctuations on their brokers, if only the customer's persuasion or the broker's negligence causes the latter to fail in carrying out Regulation T to the letter. Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of "heads-I-win tails-you-lose."[1] For these reasons, and for those given in Judge Graven's opinion in *Berzyske* v. *Chase Manhattan Bank*, 290 F.Supp. 74 (S.D.N.Y. 1968), which we affirmed "in all respects," 409 F.2d 1260, *cert. denied*, 396 U.S. 904 (1969), I would not find the decision under the anti-trust laws in *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), to be truly pertinent even if there had been more of a consensuus among the Justices than there was.

The majority's reason for imposing civil liability thus fails, and I see no other supporting rationale to sustain the result reached in this case. To be sure, it may be proper in some instances to impose civil liability in furtherance of the subsidiary purpose of §7(c), protection of the innocent "lamb" attracted to speculation by the possibility of large profits with low capital investment. That was the

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[1] *See* Comment, Securities Exchange Act of 1934—Civil Remedies Based upon Illegal Extension of Credit in Violation of Regulation T, 64 Mich. L. Rev. 940, 953-55 (1963).

situation envisioned in the dictum in *Smith* v. *Baer*, 237 F.2d 79, 87-88 (2 Cir. 1956), see also *Junger* v. *Hertz, Neumark & Warner*, —— F.2d —— (2 Cir. 1970), slip opinions, 2744, 2745 n. 1, both affirming judgments for the defendants.[4] Feuerstein, an experienced speculator, was no lamb, and the trial judge specifically found that he was not induced to enter into the transactions by any expectation that defendant would be slow in selling him out if he were to default in payment.

A view similar to that advocated in this opinion was taken in *Herzyske* v. *Chase Manhattan Bank*, 290 F. Supp. 74, 88-90 (S.D.N.Y. 1968), *aff'd* mem., 409 F.2d 1360 (2 Cir.), *cert. denied*, 396 U.S. 904 (1969), which the majority cites as somehow opposing recognition of the plaintiff's fault as a defense in cases of this sort, and in Judge Bartels' thoughtful opinion in *Moscarelli* v. *Stamm*, 288 F. Supp. 453, 458-60 (E.D.N.Y. 1968), also cited by the majority, fn. 7. I would follow the lead of these cases and deny recovery on the theory of an implied cause of action.

Although the majority does not reach the issue, I would reach the same result if liability were here sought to be justified under §29(b) of the Securities Exchange Act. That section provides in pertinent part that "Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship in violation of, any provi-

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[4] As Professor Loss has observed, many of the *nisi prius* decisions relied on by the plaintiff and the majority have simply refused to dismiss a complaint containing adequate allegations of causation and have postponed that issue until trial. 5 Securities Regulation 2996 (1969). There have been few appellate decisions, indeed none that is in any way controlling here.

sion of this title or any rule or regulation thereunder, shall be void . . ." as regards the rights of violators. Here the contract was not in violation of any provision of the statute or any rule or regulation; its performance would not have involved any violation if Pearlstein had done as he was obligated; and the court is not here asked to enforce anything that constitutes a violation. Contrast *Kaiser-Frazer Corp.* v. *Otis & Co.*, 195 F.2d 838 (2 Cir.), *cert. denied*, 344 U.S. 856 (1962). Despite the Draconian language, §29(b) does not provide a pat legislative formula for solving every case in which a contract and a violation concur. Rather it was a legislative direction to apply common-law principles of illegal bargain, enacted at a time when it seemed much more likely than it might now that courts would fail to do this without explicit legislative instruction. See *D. R. Wilder Manufacturing Co.* v. *Corn Products Refining Co.*, 236 U.S. 165, 174-75 (1915). There has been a conspicuous lack of judicial enthusiasm for the doctrine thus incorporated when there has been performance by the violator; the reasons are clearly set forth in *Bruce's Juices, Inc.* v. *American Can Co.*, 330 U.S. 743, 752-57 (1947), and *Kelly* v. *Kosuga*, 358 U.S. 516, 519-21 (1959).

Pearlstein's claim for restitution based on §29(b) is, if anything, even less attractive. Courts cannot recall too often Lord Mansfield's observation that the action for money had and received "is the most favorable way in which he [the defendant] can be sued" since he "may defend himself by everything which shows that the plaintiff, *ex aequo & bono*, is not intitled to the whole of his demand, or to any part of it." *Moses* v. *Macferlan*, 2 Burr, 1005,

1010, 97 Eng. Rep. 676 (K.B. 1760). Equity and justice are qualities that Pearlstein's claim conspicuously lacks. He bought the bonds against defendant's advice, refused to sell them on its urging, remained silent when defendant was pressing for payment, and settled his liability after having had legal advice. Equity would leave the loss where it lies.

I would therefore affirm the judgment dismissing the complaint, without reaching the grounds relied on by the district court.

APPENDIX C

Order Denying Rehearing

33315

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

STANLEY S. PRASLOVSKY,

Plaintiff-Appellant,

v.

SCUDDER & GERMAN, a partnership,

Defendant-Appellee.

A petition for a rehearing having been filed herein by counsel for the appellee,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

I respectfully dissent. I would grant the petition.

HENRY J. FRIENDLY
Circuit Judge

August 24, 1970

APPENDIX D

Order In Banc Denying Rehearing

33315

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

STANLEY S. PRABLOTSKY,

Plaintiff-Appellant,

v.

SCUDDER & GERMAN, a partnership,

Defendant-Appellee.

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the defendant-appellee,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied, Judges Lumbard, Moore, Friendly and Hays dissenting.

/s/ J. EDWARD LUMBARD
Chief Judge

August 24, 1970

APPENDIX E

Securities Exchange Act of 1934, As Amended 15 U.S.C. §§ 78a, et seq.

* * * * *

Margin Requirements

SEC. 7. * * *

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

* * * * *

Validity of Contracts

SEC. 29. (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision

of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation.

APPENDIX F

Regulation T, 12 C.F.R. Part 220
Rule 4, 12 C.F.R. § 220.4

* * * * *

Special Cash Account

(c) (1) In a special cash account, a creditor may effect for or with any customer bona fide cash transactions in securities in which the creditor may:

(i) Purchase any security for, or sell any security to, any customer, provided funds sufficient for the purpose are already held in the account or the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security prior to making such payment.

(ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account.

(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)-(7) of this paragraph, promptly cancel or otherwise, liquidate the transaction or the unsettled portion thereof.

(3) If the security when so purchased is an unissued security, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is made available by the issuer for delivery to purchasers. If the security when so purchased is a "when distributed" security which is to be distributed in accordance with a published plan, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is so distributed. If the security when so purchased is a new security issued or to be issued for the purpose of refunding outstanding securities which mature, or are to be payable upon presentation for redemption, within 35 days of the date on which the new security is made available by the issuer for delivery to purchasers, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after such maturity or payment date: *Provided*, That this sentence shall apply only to the payment of that portion of the purchase price that does not exceed 103 percent of the amount that will be payable to the purchaser of the new security upon such maturity of, or payment for, securities owned by him at the time of the purchase. [As amended effective May 15, 1965, 30 F. R. 5827.]

(4) If any shipment of securities is incidental to the consummation of the transaction, the period applicable to the transaction under subparagraph (2) of this paragraph shall be deemed to be extended by the number of days required for all such shipments, but not by more than 7 days.

Appendix F
Regulation T, 12 C.F.R. Part 220
Rule 4, 12 C.F.R. § 220.4

(5) If the creditor, acting in good faith in accordance with subparagraph (1) of this paragraph, purchases a security for a customer, or sells a security to a customer, with the understanding that he is to deliver the security promptly to the customer, and the full cash payment to be made promptly by the customer is to be made against such delivery, the creditor may at his option treat the transaction as one to which the period applicable under subparagraph (2) of this paragraph is not the 7 days therein specified but 35 days after the date of such purchase or sale.

(6) If an appropriate committee of a national securities exchange or a national securities association is satisfied that the creditor is acting in good faith in making the application, that the application relates to a *bona fide* cash transaction, and that exceptional circumstances warrant such action, such committee, on application of the creditor, (i) may extend any period specified in subparagraphs (2), (3), (4) or (5) of this paragraph for one or more limited periods commensurate with the circumstances, or (ii), in case a security purchased by the customer in the special cash account is a margin or exempted security, may authorize the transfer of the transaction to a general account, special bond account, special convertible security account, or special omnibus account and completion of the transaction pursuant to the provisions of this part relating to such an account. [As amended effective July 8, 1969 (¶77,717), 34 F. R. 9199.]

(7) The 7-day periods specified in this paragraph refer to 7 full business days. The 35-day period and the 90-day period specified in this paragraph refer to calendar days,

but if the last day of any such period is a Saturday, Sunday, or holiday, such period shall be considered to end on the next full business day. For the purposes of this paragraph, a creditor may, at his option, disregard any sum due by the customer not exceeding $100.

(8) Unless funds sufficient for the purpose are already in the account, no security other than an exempted security shall be purchased for, or sold to, any customer in a special cash account with the creditor if any security other than an exempted security has been purchased by such customer in such an account during the preceding 90 days, and then, for any reason whatever, without having been previously paid for in full by the customer, the security has been sold in the account or delivered out to any broker or dealer: *Provided*, That an appropriate committee of a national securities exchange or a national securities association, on application of the creditor, may authorize the creditor to disregard for the purposes of this subparagraph any given instance of the type therein described if the committee is satisfied that both creditor and customer are acting in good faith and that circumstances warrant such authorization. For the purposes of this subparagraph, the cancellation of a transaction, otherwise than to correct an error, shall be deemed to constitute a sale. The creditor may disregard for the purposes of this subparagraph a sale without prior payment provided full cash payment is received within the period described by subparagraph (2) of this paragraph and the customer has not withdrawn the proceeds of sale on or before the day on which such payment (and also final payment of any check received in that connection) is re-

ceived. The creditor may so disregard a delivery of a security to another broker or dealer provided such delivery was for deposit into a special cash account which the latter broker or dealer maintains for the same customer and in which account there are already sufficient funds to pay for the security so purchased; and for the purpose of determining in that connection the status of a customer's account at another broker or dealer, a creditor may rely upon a written statement which he accepts in good faith from such other broker or dealer.